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Managing Editor

The NEW YORK CERTIFIED PUBLIC ACCOUNTANT *is published monthly. Copies may be obtained at the office of the Society at twenty-five cents per copy, $3.00 per year.*

STATE SOCIETY ACTIVITIES

Calendar of Events

December 2—4:30 P. M. Special Technical Meeting. Subject: **Savings and Loan Association Accounting.** Location: Society's Office, 15 E. 41st Street, New York City.

December 4—Regular Meeting of the Board of Directors.

December 4—7:30 P. M. Special Technical Meeting. Subject: **Municipal and Local Taxation.** Location: Engineering Auditorium, 29 W. 39th Street, New York City.

December 8—7:30 P. M. Society Meeting. Subject: **State Taxation.** Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

December 9—4:30 P. M. Special Technical Meeting. Subject: **Beverage Accounting.** Location: Society's Office, 15 E. 41st Street, New York City.

December 11—7:30 P. M. Special Technical Meeting. Subject: **Administration of Accounting Engagements.** Location: Engineering Auditorium, 29 W. 39th Street, New York City.

December 15— 8 P. M. Special Tax Meeting. Subject: **Inventory and Other Year-End Tax Problems.** Location: Engineering Auditorium, 29 W. 39th Street, New York City.

December 16—4:30 P. M. Special Technical Meeting. Subject: **Dairy Industry Accounting.** Location: Society's Office, 15 E. 41st Street, New York City.

December 18—7:30 P. M. Special Technical Meeting. Subject: **Practice Procedure.** Location: Engineering Auditorium, 29 W. 39th Street, New York City.

January 8—Regular Meeting of the Board of Directors.

January 12—7:30 P. M. Society Meeting. Subject: **The Business Outlook, Inflation, and Problems Confronting Public Accountants.** Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

January 19—8 P. M. Special Tax Meeting. Subject: **Tax Problems Involving Depreciation, Depletion, and Amortization.** Location: Engineering Auditorium, 29 W. 39th Street, New York City.

New Society Director

To fill the vacancy on the Society's Board of Directors caused by the election of Mr. Saul Levy, former Director, as Second Vice President, the Board at its meeting on October 20, 1941, chose Mr. John A. Lindquist to fill Mr. Levy's unexpired term.

Board of Directors Appointments

At its meeting on November 13, 1941, the Society's Board of Directors changed the title of Mr. Wentworth F. Gantt from Assistant to the President to Executive Secretary, and named Mr. Joseph W. Welsh as Director of Public Relations.

Forthcoming Tax Meetings

As recently announced, the Society's Committee on Federal Taxation is planning a series of monthly tax meetings during the year for

discussion of various new developments and problems of interest to members in the field of taxation.

The first of these special meetings is being held December 15th in the main auditorium of the Engineering Society Building, 29 West 39th Street, commencing at 8:00 p.m. This meeting will be in charge of Nathaniel B. Bergman in cooperation with Messrs. Byerly and Meyer, members of the Committee. The subject will be "Inventory and Other Year-End Tax Problems," on which a short paper will be presented. The greater part of the meeting will be devoted to discussion from the floor, and the answering of questions proposed by members.

The Committee has also announced that on Monday evening, January 19th, at the Engineering Auditorium, the second meeting in this tax series will take place, the subject to be "Tax Problems Involving Depreciation, Depletion, and Amortization." The meeting will be conducted by Francis P. Byerly, member of the Committee.

A similar federal tax session will be held at the same place on February 9, 1942, the subject of which will be announced later by the Federal Tax Committee.

Plans have already been made to change the date of the regular Society meeting scheduled for March 23, 1942, to the date of the tax meeting scheduled for the evening of March 2nd. The March 2nd meeting, therefore, will constitute the regular March meeting at which Society business may be taken up. The subject matter and conduct of the meeting will be in the hands of the Federal Taxation Committee, which will subsequently announce the topics planned for discussion. It is expected that this particular session will be devoted to last minute discussions of tax problems coming up before the March 15th deadline.

Federal Tax Meeting

On the evening of November 17, 1941, 1,350 members of the Society had the pleasure of hearing two excellent papers on 1941 federal income and excess-profits taxes presented by Messrs. J. K. Lasser and Walter A. Cooper, members of the Committee on Federal Taxation. The meeting was ably conducted by Mr. J. S. Seidman, Chairman of this Committee, who was assisted by Mr. Leslie Mills, Vice Chairman. The two papers are published in this issue of the NEW YORK CERTIFIED PUBLIC ACCOUNTANT.

In introducing the speakers, Mr. Seidman commented upon the general tax picture and stated that in his opinion the present complicated and multiplied tax laws are a serious impediment to the defense production. He called for the drafting of a simple, integrated tax law which would be imposed at sufficiently high rates to yield the necessary revenue.

Meeting on State Taxation

The Society's annual meeting devoted to the subject of New York State taxes was held on the evening of December 8, 1941, at the Waldorf-Astoria Hotel. Members had the pleasure of hearing an address by the Hon. Joseph M. Mesnig, State Tax Commissioner, who spoke on "Accountancy and Tax Administration." Mr. Isidor Sack presented a paper entitled "Significant 1941 Changes in New York State Tax Laws, Regulations, and Rulings" and Mr. J. B. C. Woods spoke on "Allocation of Income and Segregation of Assets in State Taxation."

Syracuse and Rochester Tax Meetings

On November 26, 1941, Mr. J. S. Seidman addressed a joint dinner meeting of the National Association

of Cost Accountants, the New York State Society of Certified Public Accountants, and the Controllers Institute of America at the University Club, Syracuse, New York. Mr. Seidman spoke on "The Growing Tax Burden" and followed his talk by a discussion period in which he answered a number of questions from the floor dealing with federal taxation and the Revenue Act of 1941. The meeting, to which members of the Syracuse Chamber of Commerce were invited as guests, was well attended by a large group of accountants.

On December 9, 1941 Mr. Seidman spoke before a luncheon meeting of the Rochester Chamber of Commerce, his subject being "Pointers on 1941 Federal Income and Excess-Profits Taxes." Many members of the Rochester Chamber of Commerce attended, as well as representatives from the Rochester chapters of the New York State Society of Certified Public Accountants and the National Association of Cost Accountants.

Addresses By Members

On October 29, 1941, J. Arthur Marvin, Second Vice-President of the Society, addressed a Rutgers University Seminar devoted to accounting requirements of the Securities and Exchange Commission on the subject of "Form and Content of Balance Sheet and Statement of Surplus to be Filed under the Securities Act of 1933 and the Securities Exchange Act of 1934."

On October 30, 1941, Henry B. Fernald, a member of the Society's Committee on Education, spoke on "Internal Auditing" before the Accounting Society of the College of the City of New York." He also addressed the Commercial Education Association on November 29, 1941, on "Emergency Demands on Commercial Education."

Membership in the American Institute of Accountants

A communication has been received from the Chairman of the Committee on Membership of the American Institute of Accountants, calling attention to the fact that members of other state societies may join the Institute without paying the $10 application fee. In describing the benefits of membership in the national accounting organization, the president of the American Institute of Accountants last year, in a message to Certified Public Accountants, said:

"There are only about 21,000 Certified Public Accountants in the United States. Their efforts must be coordinated through organization if they are to be effective. The means of organization must be through their state and national professional societies.

"The progress of your profession, which has taken rapid strides in recent years, can be greatly accelerated if every certified public accountant who is eligible for membership in the professional societies avails himself of this privilege."

Employment

The Committee on Employment wishes the following message called to the attention of the membership:

The Employment Committee has expanded its activities to further assist practitioners with their employment problems, particularly those members of small and medium sized firms, by making available to them the records of college students in their senior year who plan to make public accounting their life work. Within a short time the Society will have on file the applications of a number of accounting students, which will include pictures and scholastic records. Some of these students will be available for part time work, and all of them are seeking employment after the termination of the present school year.

The foregoing is in addition to the regular employment service which the Committee has maintained for a number of years. Probably you are familiar with this service; if not, you will be interested to know that both members of the Society and others seeking employment may register at the office of the Society for positions in either the public accounting or corporate accounting field. Our files now contain applications from all grades of accountants ranging from juniors up, both certified and non-certified. Some of the applicants are well qualified for positions such as office managers and comptrollers in the corporate field. No fee is charged to either the employee or employer for this service.

Every effort is made by the Committee to meet the wishes of the prospective employer relative to the number of applicants to be sent for interviews and to qualifications of such applicants. In the event that the specifications cannot be met the employer is so advised.

Inasmuch as it is largely through the membership that we learn of positions for applicants who are registered with us, the Committee would like to have you inform your clients and friends of the employment service offered by the Society. Conversely, when you are in need of accounting personnel, we will be pleased to assist you.

Fire Department Emergency Auxiliary Corps

The Fire Chief and Commissioner of New York City has asked that attention of accountants be called to the series of lectures being given each Tuesday from 7:30 to 9:30 p.m. for civilians interested in the fire fighting phase of civilian defense. Accountants residing in New York City are invited to go to their nearest fire house any evening, where they may obtain further information on these courses which are now in session. The lectures consume a total of sixty hours.

Maurice Richel

Maurice Richel, a member of the Society since May, 1923, died on October 24, 1941, at the age of 45.

Charles W. Sim

Charles W. Sim, an associate member of the Society since September, 1916, passed away on October 27, 1941.

Arthur A. Brody

Word has just been received of the death on October 29, 1941, of Arthur A. Brody, a member of the Society since November, 1922.

Meyer Epstein

Meyer Epstein, a partner of the firm of John Gordon & Co., and a member of this Society since May, 1919, died on November 1, 1941.

The Society has suffered a great loss in the passing of these valued and esteemed members.

Frank Broaker

The Society was notified of the death on November 12, 1941, of Mr. Frank Broaker, a former member of the Society and one of the most prominent men in the accounting profession. Mr. Broaker, who held certificate number one of the State of New York, was instrumental in obtaining passage of the first certified public accountancy law in 1896, and became Secretary of the first New York State Board of Examiners. He was a well-known writer on accountancy, being the author of the first text book on this subject published in the country. Mr. Broaker was in his seventy-ninth year.

Cognizance of Mr. Broaker's death was made at a meeting of the Society's Board of Directors on November 13, 1941, and noted in the minutes thereof.

PROFESSIONAL COMMENT

Regulation of Consumer Credit

Of much interest and import to accountants and their clients will be an article entitled "Federal Reserve Regulations of Consumer Credit," appearing in the December, 1941 issue of the JOURNAL OF ACCOUNTANCY. Written by William F. Treiber, assistant counsel of the Federal Reserve Bank of New York, it describes the workings of Regulation W dealing with the control of instalment buying.

Under the provisions of this Regulation, which became effective on September 1, 1941, all firms, corporations or individuals are now required to be licensed if they are engaged in:

1) making extensions of instalment sale credit, i.e., selling listed articles on the instalment plan;
2) making extensions of instalment loan credit, i.e., making instalment loans in any amount secured by listed articles recently purchased, or instalment loans for $1500 or less, not so secured; or
3) lending on the security of or discounting or purchasing notes or other obligations or claims arising out of such extensions of credit.

To continue extending such instalment credit after January 1, 1942, it will be necessary for all firms, corporations or individuals doing so to file a registration statement before that date with the Federal Reserve banks of the districts in which the main office of such firm, corporation or individual is located. The registration form is designated as *Form F. R. 563*, and may be secured from any Federal Reserve bank.

Wages and Hours

Fluctuating Work Week

The Fair Labor Standards Act provides for the payment of one and one-half time the "regular rate" for overtime.

The Administrator has ruled that in the case of persons employed at a fixed weekly salary, the "regular rate" is the hourly rate, determined by dividing the number of hours worked during the week into the weekly salary. Under this procedure there is a rather incongruous result, if overtime is worked.

An example of the method used by the Administrator in determining a violation is presented as follows:

Suppose an employee has contracted to work for $25.00 per week on the basis of a fluctuating workweek.

Suppose that in the week under consideration, the employee worked 50 hours.

The Wage-Hour people find that the "regular rate" is fifty cents per hour, the amount earned is $27.50 and the underpayment amounts to $2.50. The following calculation serves as the basis for this determination:

50 hours divided into $25.00 equal 50 cents per hour.

40 hours at .50 equal	$20.00
10 hours at .75 equal	7.50
Total Earned	$27.50
Amount Paid	25.00
Underpayment	$ 2.50

If the employer attempts to increase the weekly salary, the result is an increase in the hourly "regular rate" and a continued violation.

Decisions Contrary to Above

Recent court decisions covering employees engaged by the week, imply that such an employee's "regular rate" is the weekly rate. If this weekly rate is sufficient to cover both regular time and overtime, using the minimum wage as a basis, there is no violation.

If the minimum wage were .30 per hour and the employee worked 50 hours for $25.00, there would be no violation because the $25.00 would be in excess of the minimum requirements of the Act, thus:

40 hours at 30 cents per hour are	$12.00
10 hours at 45 cents per hour are	4.50
Total	$16.50

See Cases

Fleming *vs.* Belo Corporation. Federal Circuit Court of Appeals, Fifth Circuit. (Being reviewed by the U. S. Supreme Court).

Floyd *vs.* Du Bois Soap Co., Ohio Court of Appeals.

Missel *vs.* Overnight Trans. Co. U. S. District Court of Maryland.

SAMUEL I. POTTER, C.P.A.

Cooperation between Certified Public Accountants and Lawyers

"May I close with a suggestion of warning? My profession of law has flourished only in the free atmosphere of constitutional government. Yours will grow and develop as a profession only under similar circumstances. There are those in the world, not only abroad but here at home, who would like to see all of the professions socialized, that is, made completely subservient to government bureaus under political control, depriving us of the status of independent professional workers having ethical standards which we will maintain either against individuals or the government itself, and would reduce us in their planned scheme of affairs to little more than law clerks and bookkeepers doing the detail work parceled out to us by the political bureaus. Already there is a tendency to curb the independence of the professions, both by statute and by rules and regulations in the government departments. Without adopting any resolutions, let us mentally resolve that any rules and regulations promulgated shall be subjected to the test of the real public good rather than mere bureaucratic convenience."

From an address by D. A. Simmons, former president of the Texas Bar Association, before the Texas Society of Certified Public Accountants, September 10, 1941.

The McKesson and Robbins Case: Verification of Stock

"In an article published on 1st March last we summarized conclusions arrived at by the American Securities and Exchange Commission on the subject of the verification by auditors of stock-in-trade, as arising out of the *McKesson and Robbins* case, and we offered certain comments of our own which were, in the main, critical of the American viewpoint. Our remarks have subsequently attracted a number of letters to our correspondence columns in which we, in our turn, have been the object of friendly criticism, and we feel that the time has arrived when it is proper that we should endeavour to think again and to restate, with the assistance of our correspondents, the whole matter as it now appears to us.

"In accounting, as in every other subject of human thought, it is inevitable that there should be a clear line of cleavage on opposite sides of which are ranged, respectively, the minds which feel the attraction of adjustment to changing condi-

tions and those which regard caution as a surer guide to conduct than boldness. Across that intellectual gulf the flinging of countercharges of timidity and rashness is futile; the practical man must be the arbiter and must remind the contending factions that auditing is a job which, by its very nature, must rely less on general statements of principle than on adaptations of variable technique to meet the almost incredible heterogeneity of factual combinations making up the material on which auditors must work. That is why, in England, emphasis has always been laid more strongly on the personal equation in auditing than on an appeal to any code of operations laid down *in vacuo* by external authority.

"Remembering this, we consider it our duty to remind our readers that there is a fundamental difference between allowing an auditor the liberty to take his tests, in particular cases, farther than may be the general practice, and laying down a fixed rule that he must in every instance carry his inquiry to a given minimum of minuteness. This flexibility appears to us to be the very stuff of which good auditing is made. It induces in the auditor a conviction of the uniqueness of every engagement, demanding special and separate consideration for every case, and it reminds those who rely on auditors that the work is an assessment of special needs rather than a mechanical task performed with line and foot-rule.

"A layman reading our recent correspondence columns might be forgiven if he should gain the impression that British auditors, under current practice, give no examination to inventories beyond the cursory acceptance of certified lists. That view of the situation would plainly be wrong; for we apprehend that every well-performed audit brings the query 'what test for this item is necessary and reasonably feasible?' The difficulty of a generalised discussion lies in the definition of feasibility. It certainly goes as far as comparison of the balance sheet item with such integral parts of the records as exist; but how much farther it can go towards reconciliation of records with the facts they purport to reflect is a question to which the answer is as variable as the facts themselves.

"We do not believe that an obligation to examine physical stock, that is to say the goods themselves, should in any circumstances be erected into a general rule of auditing; but we do believe that any good auditor should be capable of being trusted to know how far he himself can safely act on his own discretion. In saying this we express two very broad principles of the most fundamental importance.

"First, in a field where the ordinary reader of a balance sheet cannot be expected to draw fine distinctions, there is grave danger that obligatory examination of goods might draw upon the profession a responsibility it could not honestly discharge. As we have before said, no auditor is trained to distinguish between quality A and quality B of any given class of goods; nor even, in many cases, between goods C and goods D. Yet, where obligation is once accepted, how is the person who relies on the auditor to be informed what degree of strength is to be attached to his reliance? If it be argued against our view that this leaves balance sheets in an undesirable haziness of position, we reply that certainty, or what is as nearly as possible certainty, can be attained by the separate employment of professional trade valuers and stocktakers. Indeed, that course is open, even under present conditions, to any company whatsoever and we are certain it would be welcomed by auditors if only on the basic ground of relieving them of an

irksome subject of doubt. Why load auditors with a job for which there already exists an adequately trained and organized profession?

"Second, the very foundation of auditing is that it is an independent report on what has already been done by directors; and, in our opinion, no decision taken by the auditing profession ought to diminish the responsibilities of the directorial function. Directors are persons put, by their members, into a position of trust and it is for them to discharge their trust. They bring to auditors such documentary evidence of stock-in-trade as may be proper in individual cases, and that documentary evidence is open to test by auditors. The responsibility for the custody and existence of the goods lies on the directors and that obligation ought to be emphasized by every means. The profession should be willing to test and to apply criticism but, in our judgment, it should not be willing to be drawn into a position from which it could not recede; and once it accepted an obligation to enter on the physical examination of goods, it could never be certain that false assumptions of its omniscience and omnipotence would not destroy the whole value of its work."

An editorial appearing in the August 16, 1941 issue of THE ACCOUNTANT, *official publication of the Institute of Chartered Accountants in England and Wales.*

Progress in Accounting

"Progress made in clarifying the basic principles of accounting has been more than matched by improvement of the standards or principles of disclosure. An oversimplified balance sheet, a three-figure income statement, the statement that 'tells all' in an undigested mass of footnotes are becoming rarer. It seems quite clear that the investor of today has available on the average more complete, more accurate, and more informative financial data than ever before. Moreover, to a constantly increasing degree, the financial statements included in annual reports to stockholders tend to conform to the standards of disclosure applicable to statements filed under the Securities Acts. Indeed, such conformity is mandatory under the Investment Company Act of 1940.

"Without laboring the point, which has received extended consideration from all sides, it may be well to observe that financial statements ought to be accurate, reasonably detailed, and intelligible. They should be accurate, not in the sense of portraying 'the one truth,' but in the sense in which any accounting statement presents a limited set of facts abstracted from a kaleidoscopic environment. They should be detailed in the sense that sufficient facts are reported to reveal the important relationships and trends. Of significance here is the fairly recent opinion in the matter of the American Sumatra Tobacco Company, since it contains a rather full statement of the Commission's views as to the minimum detail essential to an adequate income statement, and examines at some length the arguments which have been pressed against furnishing more informative profit and loss statements.

"Finally, financial statements should be intelligible in the sense that the descriptions given and format of presentation should facilitate rather than hamper understanding. It is important to note that the ultimate test of clarity lies not in the effect produced on the trained mind of the professional accountant who prepares or examines the statement, but rather in the effect produced on the mind of the reader to whom it is directed, be he business man, lawyer, or layman. Educational efforts in this direction have resulted in the

publication by the Institute of pamphlets describing in simple language the functions of accountants and the meaning of financial statements. One research bulletin has voiced approval of such a combined presentation of income and surplus statements as should enable the reader to grasp their over-all significance irrespective of the allocation of items between them. The American Accounting Association has also sought to resolve the latter problem by recommending that all charges and credits for expenses, losses and profits be routed through the income account."

From an address by William W. Werntz, Chief Accountant, Securities and Exchange Commission, before the Fifty-Fourth Annual Meeting of the American Institute of Accountants, September 16, 1941.

Future Trends in Accounting

"Some of the trends already noted are likely to continue and to become more pronounced. Others, however, may be reversed, just as the trend towards adjusting property accounts to reflect current values that was marked in the twenties was reversed in the thirties. In particular, I look or at least hope for some reversal or moderation of the tendency to discredit conservatism and to criticise anticipation of losses foreseen but neither assured nor measurable.

Conservatism

"There is danger in attaching too much importance to the results of a single period, whether it be an hour, a day, a month or a year. No one would approve of computing the profits of a restaurant by hourly periods and allocating all fixed expenses, such as rent, on an hourly basis with the result that the business would appear to have made large profits in three or four hours of the twenty-four; to have broken about even in another few hours, and to have lost money in the remaining hours. They would insist that continuance of operation during unprofitable hours was a necessary condition of securing large revenues in other hours, and that provision for the costs of the slack periods should be made out of the revenues of the busy hours.

"Much the same considerations apply at times to annual business profits. It seems certain that the rich harvest which many corporations are now reaping will have an aftermath in which the crop will be very lean, and it would seem that corporations should take this fact into account in measuring the charges that ought to be made against the present gross yields. This is particularly applicable to new capital expenditures made from either patriotic or profit-earning motives to meet needs which are not likely to be permanent.

"Experience in the last war showed that facilities created in such an emergency often prove to be not merely valueless but a burden when the emergency has passed. Many assets not subject to the amortization provisions of the tax law may wisely be written off more rapidly than by the straight-line depreciation method. And as prices rise, it will be prudent to recognize the illusory character of profits derived from turning over commodities at higher nominal prices, expressed in terms of a depreciating currency. The establishment of reserves in anticipation of the after effects of the present happenings, through charges against current profits, is in my judgment highly desirable.

Original Cost

"I think we shall see further development of the idea of original cost and enterprise accounting, possibly in connection with the efforts that are being made to reduce the part played by loans in the capital structure of the corporate enterprise of the country, particularly in the

railway and public utility fields. This may lead to changes in taxation policies. It is a strange anomoly that we should tax the entrepreneur more heavily than the rentier (as we do by taxing equity earnings to both the corporation and the stockholder) while striving to increase the proportion of equity capital.

"We may perhaps see accounts presented in two sections—one showing the results of the operation of the enterprise as such and the other carrying on the story to show the effect of such operations on the corporation which is carrying on the enterprise. However, such a development would present difficult problems which could not be solved without long and arduous study.

Kinds of Income

"It is to be expected that realization of the great significance of the income account will lead to recognition of the importance of distinguishing between different kinds of income and to a more careful analysis of revenues or gross income and the charges thereagainst. If we are computing capital values from income it obviously makes a great difference whether the income is (a) operating income, (b) income from a prior charge on operating income of another corporation (such as interest), (c) an equity interest in such income (dividends), or (d) a gain resulting from the increase in value of an interest in income of another corporation (capital gain). The Investment Company Act of 1940, through its provisions dealing with the treatment of capital gains and losses in relation to dividends, may start a train of events of great importance in accounting.

"In this field the question may be raised whether the use of the accrual basis of accounting is worth retaining in respect of revenues, or whether the loss of theoretical accuracy resulting from its abandonment would not be worth while in order to make uniform the rule that income is *realized* gain.

More Refinement in General Accounting

"I think financial accounting is likely in the future to become more analytical and marked by greater refinement. Cost accounting techniques have superseded the old hit or miss methods of allocating overhead expenses and have led to the use of allocations based on more intensive analysis of the nature and incidence of costs. There is room for similar developments in the field of general financial accounting.

"We shall also almost certainly see further efforts—some of them, perhaps, of a radical character—to make the terminology of accounting more understandable by the general public, or at least to remove some of the opportunities for misunderstanding. In recent years, practicing accountants have made successful efforts to eliminate the use of the expression 'net worth' because it carried a connotation of value which might be misleading in respect of accounts based predominantly on cost. At the meeting of the American Institute of Accountants held within the last two weeks a proposal to eliminate the word 'surplus' on similar grounds received a cordial welcome.

"The laws of some important states permit the payment of dividends from either surplus; i.e., an excess of assets over liabilities and legal capital, which is a value concept, or net profits, which is not a value concept. In such circumstances, the substitution of the expression 'earned surplus' for the older 'undivided profits' was a step backwards which should itself be reversed.

"At the meeting to which I have referred, the Chief Accountant of the Securities and Exchange Com-

mission expressed the view that the objects of accounting were so different from those of legal rules that it should not be greatly influenced by them. A distinction may perhaps usefully be made between rules governing the determination of income and those which relate to the question whether dispositions shall be regarded as dispositions of income or of capital.

"The speaker was clearly correct in the view that legislation cannot make what is not income into income if the criteria which determine what is income are primarily economic. However, even in the field of income determination, laws have a certain relevance as indicative of legislative concepts of utility. An illustration may be found in laws which in general permit only income to be distributed but expressly provide that in determining divisible income of mines no deduction need be made for depletion.

"Once income has been determined, whether it alone shall be distributable at the discretion of directors, or whether they shall also be free to distribute part of the capital paid in and if so in what circumstances distributions may or shall be deemed to be made from one source or the other, would seem to be matters for decisions by the legislature in accord with its view of what is in the public interest. We may deplore the latitude allowed to directors under some laws as to the basis for what are called dividends; we may regret that it is no longer universally true that 'Dividends are supposed to be paid out of profits only, and when directors order a dividend, to any given amount, without expressly saying so, they impliedly declare to the world that the company has made profits, which justify such a dividend.' (Burnes *v.* Pennell, 2 House of Lords Cases, 497; 1849); but we cannot deprive directors of the right which the law gives them. We can and should endeavor to persuade them to refrain from a course which we regard as undesirable, and we can insist on full disclosure. I would call your attention to the fact that in its last bulletin, dealing with stock dividends, the Committee on Accounting Procedure of the American Institute of Accountants has not restricted itself to stating its opinion on the principles involved in accounting for stock dividends, but has expressed views on related questions of sound corporate policy in the general field of accounting."

From an address by George Oliver May before the Tenth Annual Meeting of the Controllers Institute of America, September 30, 1941.

Important Changes in the Excess Profits Tax Law Enacted during 1941

By Walter A. Cooper, C.P.A.

SHALL dispense with the formality of introducing my subject and open my part of this evening's program by stating that there are four important changes in the excess profits tax sub-chapter, on which we may well spend some time, and which I shall discuss as fully as the available time will permit. They are:

(1) The transposition of the tax deductions.

(2) The additional invested capital allowance for new capital.

These two amendments apply to taxable years beginning on or after January 1, 1941. For convenience, I shall hereafter refer to that date, which you should understand to mean (unless I indicate otherwise) either January 1, 1941 or the beginning of the first taxable year starting after that date.

(3) The addition of Section 734.

(4) The additions to, or modifications in, the relief provisions.

The two changes last mentioned are retroactive to the beginning of the excess profits tax.

Transposition of Tax Deductions

Congress has reclassified the two important Federal tax deductions and changed the order in which they are to be deducted in determining the several net incomes subject to the several taxes. Under the new plan the income tax is not deducted to determine the amount subject to excess profits tax but the excess profits tax is deducted to determine the income subject to income tax and surtax.

In order to equalize those deductions which are limited to a percentage of income such as contributions and depletion, the provisions dealing with such deductions have been modified to apply the percentage limitation to the particular net income that is to be taxed. Thus, for example, in computing the 5% limitation on contributions, for the purpose of determining the income subject to regular excess profits tax, neither that nor the income tax is deducted. But in determining the limitation on contributions deductions for the purpose of the income tax and surtax, the amount of the regular excess profits tax is deducted from gross income.

Congress apparently was quite surprised at and many members probably still do not understand how this magical hocuspocus with tax deductions could miraculously produce upwards of half a billion dollars of revenue. However, the result being what they sought, more revenue, the change was readily adopted. In some quarters it has been justified as an indirect means of reducing the stated 7% exemption on invested capital to an effective rate of 4.83%, which is the effect. However, those who justify the change on that basis do not seem to have brought the idea to the attention of the Secretary of the Treasury, or at least had not done so before he proposed the 6% ceiling on profits.

Aside from the fact that the change increases the tax burden, it is also important to note that it in-

Presented at the November 17, 1941 meeting on Federal Taxation of The New York State Society of Certified Public Accountants.

creases the relative advantage of the income credit method in comparison with the invested capital credit method. The former method has become more attractive or, perhaps I should say, less expensive for two reasons—the reduction from 8% to 7%, in the rate of exemption on invested capital over $5,000,000.00, and the transposition of the tax deductions which results in increasing the base period excess profits net income for exemption purposes. Hence many taxpayers will find that the income credit method which produced the higher tax for 1940 will produce the lower tax for 1941.

In passing, I might also call your attention to the fact that under the law as amended the carry-forward of unused 1940 exemptions must be computed under the law effective for 1941 though it may be based on either the income or capital credit method whichever produces the better result regardless of the method used in the 1940 return. Many taxpayers who were figuring on a carry-forward of unused exemption will find that the carry-forward has been either completely eliminated or materially reduced.

New Capital

The second important amendment adds to invested capital a special allowance for new capital. Before the amendment new capital was recognized and served to increase the invested capital by the amount thereof. Now, however, in addition to the amount normally includible, a special addition of 25% of the amount defined as new capital is added to the actual capital of the corporation for computing the credit. This reflects an attempt to induce business to acquire new capital for expansion purposes, not only to aid in the production of the materials for defense, but also to produce more income which in turn means more taxes. The recognition is limited, however, to new capital acquired during taxable years *beginning after December 31, 1940* and here, as in some other provisions of the excess profits tax sub-chapter, we find that those who were patriotic enough to go ahead without inducements are denied the benefit of these special allowances.

Furthermore, there seems to be no sound reason why the happenstance of a fiscal year should forever deny to a taxpayer the additional benefit for new capital acquired after December 31, 1940, but prior to the close of a 1941 fiscal year. Nevertheless, that is the effect of the law.

The new allowance applies only to new equity capital paid in. It does not apply to new borrowed capital or increases in equity capital resulting from retention of earnings. It does, however, include new capital which results from the capitalization of retained earnings through the issuance of a taxable stock dividend. It applies only in the determination of the credit on the invested capital basis and does not apply to the determination of the capital additions, 8% of which may be added to the base period income of corporations using the income credit method.

As is usual with most of these special provisions, they are complicated, contain safeguards intended to prevent the improper use of the new allowances and, as has happened before, the safeguards and limitations are not properly coordinated and leave either loopholes or inequities against the taxpayer. These three features of the new capital provisions will be discussed:

(1) What constitutes new capital which is recognized?

(2) What deductions must be made therefrom, and

(3) What limitations must be applied in determining the amount?

At this point it may be well to point out that the procedure to follow is to determine the invested capital paid in, earned or borrowed in the usual manner as we would without this new provision; then, determine the amount of "new capital" and add to the result previously developed 25% of the amount of the recognized new capital. All the inclusions, deductions or limitations I shall discuss have no bearing on the ordinary determination of invested capital, but relate only to the determination of the "new capital," 25% of which is then added to the actual invested capital. In accordance with the general method, the amount of new capital is determined for each day, as is the regular invested capital, though as a practical proposition it will be simpler to make the computations on an annual basis, prorating changes from the date thereof.

What constitutes new capital? It includes *all* cash or other property paid in for stock or as a contribution to capital or surplus *except* the following:

(1) Cash or property acquired in connection with what I shall, for the moment, describe as a Section 112 reorganization transaction, and

(2) Capital received by a taxpayer corporation from another member of a controlled group.

Now, to explain those two exclusions. Section 112 of the income tax chapter of the Code, relating to reorganizations, contains certain provisions relating to the exchange of property for stock in a corporation, in connection with a reorganization. Among others are Subsections (b)(3), (b)(4), and (b)(5), covering exchanges between corporations and individuals or two corporations, and Subsections (c) and (d) wherein "boot" is received in addition to securities in a corporation, a party to the reorganization. If a taxpayer corporation acquires cash or property in a transaction covered by the subparagraphs of Section 112 to which I have just referred, then the amount of the capital so obtained falls outside the pale of new capital and is not recognized as such. That follows even though in "boot" transactions some gain may have been taxed.

However, the new law goes further and redefines control, otherwise defined in Sec. 112(h), to mean ownership of either 50% of the *voting stock* or 50% of the total value of *all* shares outstanding. Hence, if a transaction falls under the stated sub-sections of Section 112 or would do so if control specified in Section 112(h) were defined in the manner indicated, the capital resulting is not recognized as *new* capital. Time does not allow for a more extensive discussion of this feature.

The second exclusion or non-recognition reflects an attempt to prevent corporate chains from improperly developing new capital allowances through inter-company transactions and hence there is excluded from the new capital classification any capital paid in to one controlled corporation by another member of the controlled group. Though consolidated returns affiliations control involves 95% voting stock ownership, control for the purpose of new capital is defined as the ownership within the group of either more than 50% of the total combined voting power of all voting stock or more than 50% of the total value of all shares of all classes of stock. Notice that the disjunctive term is used as control of either 50% of the voting power or of the value but not necessarily of both, is the yardstick determining if there is a controlled group. It follows, of course, that any capital indirectly acquired through a taxable stock dividend is not recognized either if the dividend stock goes to another member of the controlled group. For the deter-

mination of the percentage of stock owned, in order to ascertain whether or not a controlled group exists or the taxpayer is a member of it, the stockholdings immediately after the transaction are taken as the basis—not the status before the transaction.

So much for the exclusions of capital that is not recognized as new capital. After we have determined what is recognized as new capital, we must then make two deductions. They relate to:

(1) Increases in inadmissible assets, and

(2) Distributions of pre-1941 accumulated earnings.

The first deduction that is required is for the amount of the increase in inadmissible assets, as of the day for which the invested capital is being determined over the amount of the inadmissible assets at January 1, 1941 (or the beginning of the applicable fiscal year in the case of fiscal year taxpayers). This safeguard is understandable and quite necessary. However, as frequently happens with loophole provisions, the subparagraph dealing with the inadmissible asset adjustment is not properly coordinated with the other limiting provisions.

The point I have in mind is that the provision dealing with inadmissible assets does not take into account the fact that the inadmissible assets may have been increased by a transaction not producing recognized new capital, so that the adjustment will result in a double deduction if the capital obtained is not recognized as new capital in the first place. By way of illustration, assume the case of a taxpayer that obtained $1,000,000 of a new capital from a controlled corporation in the form of stock in one or more domestic corporations—in other words, inadmissible assets. Assume also that it acquired $1,000,000 of new capital from outside sources. It has thus added to its capital $2,000,000, of which $1,000,000 came from another controlled company and is not recognized, leaving $1,000,000 outside new capital. That amount, however, must be reduced by the $1,000,000 increase in inadmissible assets, leaving the corporation with no new capital, taxwise, though it has, in fact, acquired $1,000,000 new capital from outside sources.

Investments, the treatment of which is elective and which are inadmissible only if the income therefrom is excluded, are to be treated each year in accordance with the election for that year.

The second required reduction involves distributions after January 1, 1941 out of earnings accumulated prior to that date, or the applicable fiscal year date. The amount of new capital must be reduced by the amount of any distributions out of pre-1941 accumulated earnings. The theory behind that is that a corporation which pays out part of its January 1, 1941 capital, and then gets it back, is not really obtaining any new capital.

The third feature requiring study is the limitation on the recognizable new capital. The purpose of this is to prevent switching from borrowed to equity capital, with the safeguard that, in applying the limitation, operating losses should not reduce the new capital allowance.

The simplest way to explain the computation of the limitation is to use an illustrative example, which has been printed and distributed to you. I suggest that you take that in hand now.

Note, first, the assumed facts upon the basis of which the illustration has been worked out: first, that the taxpayer, we are using as our guinea pig, had on January 1, 1941, an equity capital of $6,000,000, of which $4,000,000 was paid in and $2,000,000 was earned, and a borrowed capital of $5,000,000. Between January 1,

1941 and July 1, 1942, the date as of which we are going to determine the new capital limitation, the following happened:

(1) $3,000,000 of preferred stock was sold to outsiders for $3,-000,000 cash.

(2) $1,000,000 of cash was paid in by another controlled corporation.

(3) $1,000,000 of property was acquired in a Sec. 112 transaction.

(4) $2,000,000 of bonds were retired.

(5) $1,000,000 was lost through operations in 1941.

On the basis of the foregoing assumptions, we determine the limitation as in the illustration. The aggregate of the equity and borrowed capital at July 1, 1942 is first ascertained. You will appreciate that at that point the equity capital includes only the earnings accumulated to January 1, 1942, as current year earnings do no affect equity capital during the year. Note, also, that we include borrowed capital (which is the full amount of the indebtedness)—not borrowed invested capital which is only half of the borrowed capital.

From the result of $13,000,000, we deduct the non-recognized capital additions of $2,000,000, leaving a balance, which I have described as the "adjusted daily capital," amounting to $11,000,000. That is then compared with the equity and borrowed capital at January 1, 1941, again including borrowed capital rather than borrowed invested capital, which amounts to $11,000,000.

However, we reduce that opening aggregate of equity and borrowed capital by the excess of the accumulated earnings and profits at January 1, 1941, amounting to $2,000,000, over the amount at January 1, 1942, $1,000,000, the difference of $1,000,-000 being the 1941 loss by which amount the accumulated earnings were reduced. Deducting this $1,-000,000 from the January 1, 1941 aggregate of $11,000,000 leaves $10,-000,000, which in turn is deducted from the July 1, 1942 aggregate of $11,00,000, leaving $1,000,000 which is the maximum amount which can be recognized as new capital. If the additions and deductions previously discussed resulted in a smaller amount of new capital (which would be so if there had been a substantial increase in inadmissible assets), then the smaller amount would be the new capital.

You can see that what has resulted in this assumed case is the acquisition of $5,000,000 of capital, $2,000,-000 of which does not count as new capital because it was obtained through a Section 112 transaction or from another controlled corporation, leaving $3,000,000 that came in from outsiders. Of that, $2,000,-000 was used to retire borrowed capital leaving $1,000,000.00 which is the real amount of outside new capital remaining in the enterprise, and that is how the limitation works out.

However, the statutory language does not accomplish the result really desired if some other things happen, and so I have projected this illustration to January 1, 1943, having assumed that for the year 1942 the company earned $1,000,000.00 and paid out of that a dividend of $500,000.00. In making our computation of the limitation, we find that the sum of equity and borrowed capital at January 1, 1943 is up to $13,500,000.00, the additional $500,000.00 being the undistributed 1942 earnings. We make the same deduction for the non-recognized capital of $2,000,-000.00, leaving $11,500,000.00. We then compare that with our January 1, 1941 aggregate equity and borrowed capital but find that there is no reduction to be made on account

of a decrease in accumulated earnings, as was the case in our computation as of July 1, 1942, so that when we deduct $11,000,000.00, the January 1, 1941 total, from $11,500,000.00, the January 1, 1943 total, we have a limitation of $500,000.00, which is the maximum that can be recognized as new capital.

Your obvious reaction to a consideration of this tabulation must be that I have made an error because if the company had a surplus at January 1, 1942 of $1,000,000.00, earned $1,000,000.00 and paid $500,000.00 in dividends in 1942, it would have a surplus at the beginning of 1943 of only $1,500,000.00, whereas the tabulation shows $2,000,000.00. You would be correct but so is the tabulation because the statute provides that the determination of the accumulated earnings, as of the beginning of any year subsequent to January 1, 1941, shall be made *without regard* to distributions subsequent to January 1, 1941. Thus, in determining accumulated earnings, we cannot deduct the dividend distributions. It is not believed that one indicated result was intended by the framers of the legislation, but, nevertheless, until the law is changed such is its effect.

Section 734

The addition of Section 734 came as quite a shock to many tax practitioners last Spring and put a sudden end to the many discussions then going on about the extent to which items previously charged off on tax returns could be reinstated either for invested capital or base period income determinations. Fundamentally Section 734 is an attempt to mitigate the effect of the Statute of Limitations as was Section 3801 of the Code. However, it is much broader and, in some respects, I might say its most important aspects, its meaning and intent are uncertain. I understand, however, that it is to undergo a substantial overhauling in the procedural bill, about which we have heard so much but seen so little.

Basically, the purpose of Section 734 is to prevent the correction of a prior erroneous treatment of any item and, as the Treasury says, any transaction, in the computation of income or invested capital credits without correspondingly correcting the prior tax liability. Note particularly that it becomes operative only with respect to the inconsistent treatment of items in the computation of credits and is not concerned with the computation of current year net income. That presumably, is covered by Section 3801.

It makes no difference who made the error or why or that the treatment may not have been erroneous in the light of bureau rulings or court decisions at the time the item was originally considered.

In its method of operation Section 734 requires that the tax for the prior year be recomputed and that the additional tax resulting from the correction only of the erroneous treatment of the item, plus interest from the ordinary due date thereof to the regular due date of the Excess Profits Tax, be added to the latter and become a part of the Excess Profits tax liability. You will observe that the effect of the method provided, which is different from the method of adjustment under Section 3801, converts what would ordinarily be an interest payment (and hence deductible in computing all Federal taxes) into an excess profits tax liability which is not deductible in figuring the income subject to excess profits tax and by statutory limitation this Sec. 734 tax and interest adjustment is not deductible in computing normal tax net income either. This is a further penalty because the excess profits tax as such is deductible for income tax purposes. Hence, if the reduction in excess profits tax

is offset by a Sec. 734 addition—leaving unchanged the total amount payable—only the amount of the *reduced* regular excess profits tax is deductible for income tax purposes.

Section 734 is applicable only if adjustment of the prior year tax liability is barred by the limitations provisions. Hence, if a correction of an open year is required, a taxpayer would be well advised to voluntarily pay the deficiency and interest, so as to be able to deduct the *interest* for all tax computations.

If the correction of the prior year would result in a refund, the amount of such overpayment, plus interest, is deducted from the Excess Profits Tax. You should note that there can be quite a difference between the effect of a prior year overpayment or underpayment in that the benefit of the overpayment is limited to the amount of excess profits tax, which cannot be reduced to less than zero, while there is no limit on the addition of prior year underpayments, particularly as the current excess profits tax cannot be less than the sum of the prior year underpayments (less overpayments, if any), plus interest thereon. Likewise, no comparison is made between the extent to which the correction reduces the excess profits tax and the amount of the additional tax and interest for the prior years. Thus, for example, the correction of an error in a prior year return might add to the current tax a prior year adjustment of $10,000 even though correct treatment of the item in computing the credit saves but $1,000 of current excess profits tax. Thus taxpayers may be faced with another gamble in settling their tax liabilities because, while the prior year adjustment is made but once, the benefit in the credit computations will be perpetual and even though the prior year adjustment will exceed the first current year saving it may well be that in two, three or more years the current tax saving will, in the aggregate, more than offset the prior year adjustment. Whether it will or not is the gamble.

One feature of Section 734 does not seem to have been fully understood. The section applies only when the taxpayer (or the Commissioner) *maintains* an inconsistent position. In many cases it is presently uncertain whether Section 734 does or does not apply. There is nothing to prevent a taxpayer from making a claim for proper adjustment, in computing the current tax liability, and then withdrawing that claim at a later date if it should be held that Section 734 is applicable; in other words, the taxpayer must *maintain* the inconsistent position and, even though the return may have been prepared on an inconsistent basis, its inconsistent claims can be withdrawn on settlement. The regulations state that the taxpayer must *assert and maintain* an inconsistent position.

The principal uncertainties involve two features, to wit:

(1) The meaning of the term predecessor.

(2) The type of item or transaction covered by Section 734.

Section 734 applies when an item was erroneously treated in the determination of the tax liability of the taxpayer or a "predecessor." The statute does not define "predecessor." The term, as you readily appreciate, is much broader than the term "transferor." It can include a predecessor business or predecessor owner of assets and is obviously not limited to predecessors or transferors in a non-taxable exchange. The regulations throw no light on the problem.

The second uncertainty arises out of the terms of the regulations issued under Section 734. The statute refers only to the treatment of "an item;" the regulations on the other hand refer to the treatment of an

"item or transaction." There is a world of difference between "item" and "transaction." As an illustration, if a taxpayer corporation acquires property in exchange either for cash or its own securities, the item which it acquires and with which it treated in its tax computations is the property acquired, which item was not dealt with as such in the predecessor owners' tax computations. On the other hand, the transaction would cover both items involved, to wit, the property received by the taxpayer corporation and whatever consideration it paid therefor. Thus, under Section 734's possibilities, including any predecessor and any item or transaction, a taxpayer could be held accountable for the tax which some other person or corporation failed to pay on the sale of property to the taxpayer for cash. Such a result could not have been the intention of Congress—but where is the line to be drawn?

I cannot dispose of these uncertainties for you. When the Commissioner of Internal Revenue sidesteps them who am I to step in where he (I didn't say angels) fears to tread. All I can do here is to call them to your attention. Perhaps they will be cleared up in the next Revenue Act.

Abnormalities and the Relief Thereof

The amendments to the relief sections which are retroactive to the beginning of the first excess profits tax year are most important. They represent an attempt by Congress to normalize the abnormal by providing for specific adjustments of the abnormal features.

As we know from our past experiences, abnormalities may involve one or more of three factors, to wit, the invested capital or the base period income (both of which affect the excess profits tax credits) or the current year taxable income. I will discuss the three factors in that order.

Invested Capital Abnormalities:

Abnormalities with respect to invested capital are the most difficult to take care of and, so far, the statute does not specifically take care of them—except to the extent that the use of the income credit method relieves many capital situations that would otherwise result in an abnormally high tax.

Base Period Income:

Abnormalities in connection with the base period income may relate to the following:

(1) Non-existence during all or part of the base period.

(2) Decreased base period income resulting from excessive abnormal deductions.

(3) The non-production of income, due to circumstances and events.

(4) The inequity of the straight four-year average in the case of growing corporations.

Non-Existence during Entire Base Period:

Relief is allowed to corporations which were not in existence during the entire base period under two different methods. The first allows a constructive income of 8% on the invested capital at January 1, 1940 (which is not new), and the second permits a taxpayer to ascertain the income that would have been earned during the period prior to commencement of operations on the basis of its ability to operate and produce at January 1, 1940. That is the Sec. 722 adjustment which will be discussed later. It will be noted in this connection that the constructive income relief is not granted to corporations after their organization for periods prior to the commencement of operations if there should have been an inactive gap, but Section

722 may provide some relief for such cases.

Decreased Income Resulting from Excessive Abnormal Deductions:

You will recall that in the original Excess Profits Tax Law Congress made provision for adding back to base period net income specified abnormal items such as bond retirement deductions, casualty losses, etc. I shall not discuss them because they are not new. What is important is that there has been added to the statute a provision permitting adjustment, i.e., non-deduction, for abnormal deductions of any class during any base period year. However, certain strings have been tied to the taxpayer's rights in that respect and those strings have also been added to the adjustments allowed under the law prior to amendment, for deductions attributable to claims, judgments, awards, etc., and intangible drilling and development costs. As to deductions falling in the two classes just mentioned and all other deductions not falling in one of the other classes specifically mentioned in Sec. 711, the statute lays down a specific formula for determining a taxpayer's rights to make an adjustment and the amount thereof.

The first problem to consider in connection with excessive deductions is whether it was abnormal for a taxpayer to sustain any deduction of the class involved. If it was not normal for the taxpayer to sustain any such deduction, then the entire amount thereof is regarded as abnormal. While the statute does not specify the circumstances under which it is abnormal for the taxpayer to sustain any such deduction, the Regulations provide that deductions of any class are abnormal *only* if the taxpayer had no such deduction in the four previous years. If the taxpayer was not in existence for four years prior to the particular base year under consideration, then the yardstick period consists of such prior years as it was in existence and such succeeding years as may be necessary to aggregate four years in all, taking in only succeeding years up to the beginning of the second excess profits tax year.

Let me illustrate that with an example. If we are dealing with the base period deductions of a calendar year taxpayer for the year 1938 and that taxpayer was organized January 1, 1937, it would have had one year prior to the year 1938. It would have had two years subsequent to 1938 and prior to the beginning of its second excess profits tax year which is 1941. In that case, therefore, the so-called four previous years would consist of only the three years 1937, 1939 and 1940. If it had been organized January 1, 1936, its four years would include 1936 as well as the other three years. If it had been organized January 1, 1935, its four years would then consist of the calendar years 1935, 1936, 1937 and 1939.

The Regulations stating that because a taxpayer sustained a deduction of the class involved in any of the four previous years (which as stated might involve a subsequent year in some cases) it is normal rather than abnormal for the taxpayer to sustain such deductions, is seriously open to question in my opinion. This would be particularly so if there is involved a deduction growing out of a single cause but deductible partly in each of two taxable years, such as, for example, a strike which started in December and finished in January. Such an expense is no less abnormal because part of it happened to fall in each of two taxable years instead of all in one taxable year. However, I give you what the Regulations provide and we must bear in mind that frequently Administrative interpretations take on the force and effect of law.

However, even if it is normal for the taxpayer to incur deductions of any class, an adjustment is permitted

if the amount in any particular year was abnormal. Prior to the 1941 amendments, the law referred to and allowed an adjustment for deductions which were grossly disproportionate but that very unsatisfactory term has been replaced by a specific yardstick. The law now provides that if the deduction for any particular year exceeds 125% of the average deductions of the same class for the four previous years, then the excess is the amount of the abnormal deduction. The term "four previous years" may, as I pointed out, include subsequent years.

Whether the deduction is wholly or partially abnormal, there is a further limitation in that the amount of the adjustment cannot exceed the difference between the deduction of the class involved in the particular base year and the current excess profits tax year. Let me illustrate that with some figures.

Assume, for example, we are dealing with the calendar year 1939 in which the deductions of Class X amounted to $100,000.00, and 125% of the previous four-year average deductions of Class X amounted to $60,000.00. We thus have an abnormal deduction in 1939 to the extent of the difference of $40,000.00, which would be the amount to be added back to 1939 net income if the deductions of Class X in the year 1940 did not exceed $60,000.00. If for that year they amounted to $75,000.00, then the adjustment for 1939 would be limited to the difference between the 1940 deduction of $75,000.00 and the 1939 deduction of $100,000.00 or $25,000.00. In other words, we must leave in the base year a deduction that is at least equal to the current year deduction. You can readily see that the average base period income, when these adjustments are involved, may vary with each excess profits tax year, if the current year deduction of the class involved varies from year to year and that limitation comes into play.

So much for the figures. There are two factual limitations. The first is that the taxpayer must show that the deduction or the abnormal increased amount thereof is "not a consequence of an increase in the gross income or a decrease in some other deduction in the base period." I quote those words because they are important. You will note, first, that the limitations cover the effect throughout the base period and not merely the taxable year in which the deduction is sustained. Thus, for example, if a 1938 deduction is excessive because it is a consequence of a decrease in some 1937 deduction, an adjustment is not allowable. Similarly, if it results from increased income in some other base period year, an adjustment is not allowable.

There is another peculiarity in this provision of the statute in that it denies the adjustment if the expense is a "consequence" of an increase in the gross income. Strictly interpreted, that term is very narrow and would cover such situations as percentage commissions on sales which will necessarily increase as a consequence of an increase in sales. In most situations the expense comes first, and we might say that the gross income increase is a consequence of incurring the expense rather than vice versa. So if we take the statutory language literally, that part of it will have limited application. It is quite probable, however, that the Treasury will interpret the provision broadly and apply the limitation even when the increased income is a consequence of the deduction, though there is no certainty that the courts will approve that interpretation.

The second requirement is that the taxpayer must also show that the deduction or the increase therein is not a consequence of a change *at any time* in the type, manner of operation, size, or condition of the business engaged in by the taxpayer.

Note that the taxpayer must show that the deduction is not a consequence of one of the changes in business *at any time.* The limitation is thus not even confined to the base years but can include prior or excess profits tax years as well, and in that connection the Treasury Regulations illustrate a non-adjustable item by referring to the abnormal expense growing out of the adoption of an employees' training program in 1939 in connection with business expansion, the income from which, apparently, could not be realized until 1940.

A change in type, manner of operation, size or condition of the business, if those terms are broadly interpreted will eliminate many possibilities and come close to confining adjustments to what may be called involuntary items — those which the taxpayer does not deliberately incur for operations purposes. How far we can go will be determined by decisions in particular cases and the only advice one can give now is to claim any adjustments that have some reasonable basis—and then await developments.

The final feature to cover in this discussion of abnormal base period deductions is the matter of classification. The statute merely states that deductions of any class which meet the other tests may be made the subject of adjustment, but lays down no rule for classification other than to state that it shall be in accordance with the Rules and Regulations promulgated by the Commissioner of Internal Revenue.

The Regulations which have been issued under this provision of the statute state that the items shall be grouped in such classes as are reasonable in the light of the type of business, the experience, and the accounting methods of the taxpayer. Obviously, the deductions need not be classified in accordance with the classification of Sec. 23 which allows the several deductions from gross income. The Regulations further provide that whatever classification is adopted by the taxpayer must be consistently followed thereafter. Hence the selection of the classification is most important, particularly in the light of the limitation based on the amount of the deduction of the particular class in the current excess profits tax year. For example, it may make no difference in making the classification for 1940, whether we classify an item as belonging in Class A or Class B, if there are no deductions of either Class A or B in the year 1940. If in 1941, however, we should have a deduction in Class B and not in Class A, then our selection, which will have been made in the previous year, may have an important bearing on the tax result. Naturally, the narrower the classification, the better it will be for the taxpayer. Broadening the classification to include items of other types might serve to reduce the amount of adjustment—it can never result in increasing it. Just how far one can go is presently uncertain.

Growth Corporations:

The statute was also amended to give recognition to the fact that some corporations were growing rapidly during the base period so that the use of the straight four-year average would not fairly reflect the normal earning capacity at the beginning of the excess profits tax period. To meet these situations, the growth averaging method was added to the law. This permits a taxpayer to use as its average annual base period income the average of the last half plus one-half of the excess of the aggregate income for the last half over the first half of the base period, subject to the limitation that the annual average cannot exceed any one year's income. You probably know all about that method so I shall not dwell on it further except to point out that

this growth averaging method is not available to corporations which elect the benefits of Sec. 742 under which they may include in the base period computations the net incomes of qualified component corporations.

Non-production of Income during Part of the Base Period—Section 722:

Section 722, which is new, will provide a field day for the grandstand managers or second guessers. Congress has, in effect, said to taxpayers that, if by reason of certain specified circumstances or events you did not earn during the base period what you should have earned, figure out what your income should have been and use that as the basis for exemption. Of course, it isn't quite as simple as that, but in the limited circumstances under which the provisions of Section 722 can be invoked, such will be the result. Before you start thinking too much about dipping your hand into the "Pot of Gold," let me tell you about the tough hurdles you must first overcome.

To begin with, the benefits of this new provision cannot be invoked unless a successful claim thereunder will reduce the excess profits tax otherwise payable by ten percent thereof, and let me point out here that the tax otherwise payable before the application of Section 722 includes any adjustment, addition or reduction under the provisions of Section 734 previously discussed.

You will not know whether or not that test can be met until after you have established the effect of Section 722, so let us see what that requires. To obtain the benefits of this section, a taxpayer must establish one of the five following propositions:

1. That during all or part of the base period, normal production, output or operation was interrupted or diminished by the occurrence of some abnormal event or events. Obvious illustrations of such events are strikes, floods or fires, although it is conceivable that a taxpayer may have suffered strikes, floods or fires so frequently as to have made their occurrence normal rather than abnormal.
2. That the taxpayer was in existence during only part of its base period. This, of course, is a very simple requirement to establish if it applies in any particular case.
3. That there was a difference between the products or services being furnished on January 1, 1940 and during all or part of the base period, or there was a difference in the capacity for production or operation on January 1, 1940 and all or part of the base period. Note particularly that that date January 1, 1940 is fixed, and means only that date—not the beginning of a fiscal year beginning on or after that date. Thus the status of a corporation using a fiscal year ended November 30th is fixed by its capacity for production or products on January 1, 1940—not December 1, 1940 when its first excess profits tax year began.
4. There was a difference between the ratio of non-borrowed capital to borrowed capital on January 1, 1940 and during all or part of its base period. That takes care of one capital abnormality.
5. The taxpayer before January 1, 1940 acquired a competitor and by reason of that acquisition reduced or eliminated competition.

Those tests are not difficult to apply to any given case and if one or more of the circumstances are applicable, the taxpayer should have no

difficulty in sustaining the burden of proof. I might add in this connection that high prices of any agent of production, low physical volume of sales or low sales prices are specifically barred by the statute from constituting abnormal events or occurrences which give rise to the application of Section 722.

Assuming, therefore, that the taxpayer has met the first requirement and has shown that one or more of the five circumstances described are applicable to it, the next step is to redetermine the base period income, remembering that correction may be required for more than one of the stated causes.

Redeterminations fall into two classes. First, those arising from cause number one, an interruption or diminution of production because of some abnormal event. In such cases the redetermination should add to net income the net profits that were not earned because of the loss of production.

The second class takes in all the other four situations and, as you can appreciate, they all involve cases in which the taxpayer's status at January 1, 1940 was different, and better from a net income-producing point of view, than it was during all or part of the base period. The redetermination then involves establishing what the income would have been had the taxpayer's status during all the base period been the same as on January 1, 1940—with respect to the abnormal situations mentioned. In cases to which these class two corrections apply, there is a further limitation (not applicable to the abnormal event class) to the effect that the average annual base period income as redetermined cannot exceed the excess profits net income for the last taxable year in the base period. If that last taxable period covers less than twelve months, it is put on such a base by dividing the net income by the number of months it contains and multiplying the result by twelve. In other words, the best result can only be an average equal to the last base year income.

However, in determining what its normal base period income should have been, the taxpayer must eliminate from the base period income of all years any abnormal gross income and adjust, by increasing to normal, the amount of any deductions which were abnormally small. It is important to note that these abnormal income and expense adjustments must be made for each base year, even though the events or circumstances which give rise to the application of Section 722 affect only one base year. To illustrate, if a plant was shut down by reason of an abnormal strike situation in 1939, the abnormal income and expense adjustment must be made for the years 1936, 1937 and 1938, as well as 1939.

Furthermore, the limitation on average income as redetermined for the second class, which I mentioned before—the last year's income—is the amount of the income for that last period *after* correction for abnormal income received or abnormally low deductions.

I shall not attempt to discuss in detail the manner and means by which taxpayers should determine what the income should have been or would have been, as that necessarily depends upon the peculiar circumstances of each case. Of course, there are some simple situations, such as one that recently came to my attention, which involved a parent holding corporation that liquidated its one wholly owned operating subsidiary on January 1, 1939. For the years 1936, 1937, and 1938 it had no excess profits tax net income, as its only receipts were dividends from its operating subsidiary. Its capacity for operation on January 1, 1940 was, naturally, quite different from its capacity to

operate during 1936, 1937 and 1938. Obviously the measure of the income it would have made during those three years is the income its operating subsidiary actually earned, assuming no other changes in capacity, abnormal events, etc.

The regulations issued by the Commissioner with respect to this section contain one requirement that is of the greatest importance. They require that in determining what its income should have been during the base period, the taxpayer must take into consideration general business conditions prevailing during the years to be adjusted, as well as the demand for the products, etc. during that period. The regulations illustrate the situation by referring to the case of a typewriter manufacturer which converted its plant before January 1, 1940 to the manufacture of rifles and state that, in determining what the income would have been from the manufacture of rifles during such part of the base period as it was manufacturing typewriters, it must take into account the demand for rifles. If it cannot show that it could have sold any rifles, then its income from the manufacture of rifles, had it been in that business, would have been nil. If the plant had been shut down by reason of a strike, flood, fire or similar occurrence, the taxpayer will undoubtedly be required to show that it actually lost business by reason of the shut-down and was not able to complete and fulfill all its contracts by production after its plant was able to operate again. This requirement will present a tough hurdle in some cases and may eventually involve studies of an industry as a whole to show that some particular taxpayer could have had the increased business, if it had been able to produce the goods.

Carrying on, let us assume now that you have met not only the requirements test, but have also established that the income would have been greater than the amount actually earned had it not been for the event, occurrence or lack of capacity, etc. The next step is to determine what the income credit and the excess profits tax would have been on the basis of that revised income, applying the statutory formula in the usual way. But, you don't stop there, because after the tax has been computed on that basis, there must be added to the result 10% of what the tax would have been without the application of Section 722. Even then you are not finished because, in any event, the tax under Section 722 cannot be less than 6% of the normal tax net income.

These limitations can best be brought out by an illustration, so let us assume that the regular excess profits tax computed in the normal manner would amount to $100,000. After applying the provisions of Section 722 and computing the tax under the redetermined income basis, it develops that it would amount to $50,000. To that must be added 10% of the tax before considering Section 722, which is $10,000, being 10% of $100,000, making the aggregate $60,000. If in that case the normal tax net income amounted to $1,250,000, then 6% of that normal tax net income would be $75,000, so that the taxpayer would have to pay $75,000 rather than either the $60,000 or the $100,000.

There is one important distinction between this relief provision and the other relief provisions and that is, that the benefit of Section 722 cannot be claimed on the tax return when it is filed, as in the case of the adjustments for abnormal base period deductions or abnormal current year income. A claim under Section 722 must be filed on Form 991 within six months after the due date of the excess profits tax return. That means the due date as extended if an extension was granted. How-

ever, if a taxpayer fails to make a claim within the six months period or perhaps paid no excess profits tax and therefore was not in a position to make such a claim, and a deficiency is later proposed, the taxpayer is allowed ninety days after the issuance of the preliminary notice of deficiency within which to file a claim for the benefits of Section 722. That claim also must be filed on Form 991 and, in such circumstances, the relief which the taxpayer may obtain is limited to the amount of the asserted deficiency. In other words, if the claim is not made within six months after the due date of the return, then Section 722 can be availed of only to offset a later proposed deficiency and cannot be made the basis of a refund.

What constitutes a preliminary notice of deficiency is not defined by either the statute or regulations, though when the times comes for the issuance of deficiency notices, some particular form may be adopted and designated the preliminary notice of deficiency. However, in the absence of a more specific definition or description, the only safe procedure is to regard the Revenue Agent's report as the preliminary notice and figure the ninety-day period as dating from the date of the letter transmitting that report.

This restriction upon the application of Section 722 or the availability of its benefits is eased somewhat after a taxpayer has once been granted, in a final determination, an adjustment under the Section 722. The taxpayer can thereafter use the revised base period income in all subsequent tax returns.

Abnormalities in Current Year Income—Section 721:

The fourth type of abnormality which the statute endeavors to relieve involves abnormal current year income. This provision, known as Section 721, is not new but it does have four new features.

The law originally covered six specified classes of income and permitted adjustment thereof if it was not normal for the taxpayer to derive any income from the specified sources, or if it was normal for the taxpayer to derive some income from such sources, but the amount in the taxable year was grossly disproportionate to the prior four-year average, then the disproportionate amount was regarded as abnormal and could be made the subject of correction and adjustment. The rather uncertain term "grossly disproportionate" has been eliminated and a specific yardstick has replaced it. It is now provided that the amount of the abnormal current year income is the excess thereof over 125% of the average income derived from the same class or source during the four previous years, or if the taxpayer was not in existence for four previous years, as many years as it was in existence. In this respect, the four-previous-year basis differs from the requirement with respect to abnormal base period deductions in that the taxpayer does not take into consideration any subsequent years, only preceding years, and if there were not four, then only as many as there were.

This 125% yardstick is applicable to the special classes of income previously mentioned in the law, which are continued, but in addition to the specified classes the taxpayer is also permitted to make adjustment for gross income of any class, the entire amount of which is abnormal or part of which is abnormal under the 125% rule. Permitting adjustment for any class of abnormal income is the second new feature and here, as with excessive base period deductions, the classification is up to the taxpayer, except, of course, that the six special classes previously included in the statute are continued and constitute classes by themselves. How-

ever, if an item can be included in more than one class, it must be included in whichever class the taxpayer irrevocably elects. An illustration of such an item is collection of a claim for patent infringement. It could be classified as income from a claim or from patent development. What I had to say about selecting the classification with respect to abnormal expense deductions is equally applicable with respect to selecting the classification for abnormal income items. The narrower the classification the better, and the classification must be selected with an eye to the future potentialities, because it must be remembered that the abnormal income of the year 1940 becomes part of the normal measure for the next four years, etc.

The third new feature is the requirement that abnormal gross income, after the amount thereof has been determined, must be reduced by direct costs and expenses through the expenditure of which the abnormal gross income was derived. The result is the net abnormal income which is the amount which is to be reallocated to the appropriate years. In situations wherein it is normal for the taxpayer to derive some income of the class involved, but the amount was abnormal because it exceeded 125% of the previous four-year average, there is deducted only such ratio of the direct costs and expenses as the *abnormal* income of the current year bears to the *total* income derived from the particular source during the current year. For example, if the abnormal income in the claims classification amounted to $1,000 in 1940 but the prior year average plus 25% amounted to $700, leaving only $300 abnormal in amount, which is the basis for adjustment to start with, then only 300 one-thousandths or 30% of the direct costs and expenses of 1940 are to be deducted from the abnormal income to determine the net abnormal income to be reallocated.

After the net abnormal income has been ascertained in the manner described, it must then be allocated to the applicable years in accordance with the Regulations under the rules promulgated under the old law, which remain unchanged. It follows, of course, that even though income from some source may be abnormal in a particular year, no tax benefit or saving can be obtained unless there exist circumstances under which some portion of the net abnormal income can be allocated to another year. Abnormal income, developed in any particular year wholly out of the activities of that year, and with respect to which there is no basis for allocating any part to a prior or succeeding year, remains taxable in the current year just as though it were not abnormal.

The fourth feature of Sec. 721 that has been altered relates to the determination of tax in the case of income that is allocated to future years. Prior to the 1941 amendment, there was no limit on the amount of tax that could be chargeable on income allocated to future years, and it was conceivable, and probable in view of increased rates, that such income might eventually bear a greater tax burden than if it had not been reallocated to later years. Under the amendment, however, the tax in the succeeding years cannot exceed the tax that would have been payable if the entire amount had been included in the current year and not deferred to later years. All that the taxpayer will save, if that happens, is what might be regarded as the interest the tax money might produce during the period of deferment.

The method of operation provided for this new feature is to require the taxpayer to pay each succeeding year the additional tax that results from including in each such succeed-

ing year's income the deferred income applicable thereto, until such time as the aggregate taxes in succeeding years equal what would have been paid in the year in which the income was derived, had it not been deferred. After that, the taxpayer is even, and he stops paying additional taxes on the deferred income. However, if the aggregate tax never reaches that point, the taxpayer will have saved the difference.

ILLUSTRATION OF COMPUTATION OF NEW CAPITAL LIMITATION IN THE CASE OF A CALENDAR YEAR CORPORATION

Assumed Facts:

Status at January 1, 1941—

Equity Capital paid in	$4,000,000.00
Accumulated Earnings	2,000,000.00
Borrowed Capital (Bonds)	5,000,000.00

Subsequent happenings:

(1) $3,000,000.00 of Preferred Stock was sold to outsiders for $3,000,000.00 cash.
(2) $1,000,000.00 of Cash was paid in by another controlled corporation.
(3) $1,000 000.00 of Property was acquired in a Sec. 112 transaction.
(4) $2,000,000.00 of Bonds were retired.
(5) $1,000,000.00 was lost through operations in 1941.

* * * * *

Computation of Limitation as at July 1, 1942:

Equity Invested Capital at July 1, 1942, consisting of Capital paid in to that date, plus accumulated earnings at January 1, 1942			$10,000,000.00
Borrowed Capital as of July 1, 1942			3,000,000.00
Total			$13,000,000.00
Less:			
Property acquired in a Sec. 112 transaction		$ 1,000,000.00	
Capital acquired from another member of a controlled group		1,000,000.00	2,000,000.00
Balance—Adjusted Daily Capital			$11,000,000.00
Compared with:			
Equity Invested Capital as at January 1, 1941		$ 6,000,000.00	
Borrowed Capital as at January 1, 1941		5,000,000.00	
Total		$11,000,000.00	
Less:			
Excess of Accumulated Earnings and Profits at Jan. 1, 1941	$2,000,000.00		
Over the amount as at January 1, 1942	1,000,000.00	1,000,000.00	10,000,000.00
Limitation as at July 1, 1942			$ 1,000,000.00

* * * * *

Assuming, further, Earnings of $1,000,000.00, and Dividend Payment of $500,000.00 during 1942:

Computation of Limitation as at January 1, 1943:

Equity Invested Capital as at January 1, 1943			$10,500,000.00
Borrowed Capital as at January 1, 1943			3,000,000.00
Total			$13,500,000.00
Less:			
Reductions as above			2,000,000.00
Balance—Adjusted Daily Capital			$11,500,000.00
Equity and Borrowed Capital as at January 1, 1941, as above		$11,000,000.00	
Less:			
Excess of Accumulated Earnings and Profits at Jan. 1, 1941	$2,000,000.00		
Over the amount as at January 1, 1943	2,000,000.00	-0-	11,000,000.00
New Capital Limitation as at January 1, 1943			$ 500,000.00

Technical and Business Alternatives in the Income Tax Code

By J. K. LASSER, C.P.A.

MY approach to this study of income taxes is from the viewpoint of the technical or business alternatives in the statute. Following one course may lead to a highly different result than another. In a great many cases, ours is the option. An impulsive selection may be costly.

If we pick the wrong horse, there is often no way to retract. The administration of tax laws must be of a character to bind us tightly for our errors. Collections of needed revenue would be impossible were we permitted to change our bets after the starting gun. And incidentally, it is not irreverent to bring in race track parlance in discussing taxes right after we have gone through the October nightmare of picking declared valuations by use of wish bones and dice. I am sure that a decent study of the Belmont form sheets would have given better results.

Now of course it is true that Congressional championship of one horse as against another, simultaneously charges us with knowing the performances of both horses. Our decisions, therefore, must be made only after convincing demonstrations of our reasoning.

I have classified a dozen of the more important of these taxpayers' St. Bernard dogs in the outline before you.

1. Corporation vs. Other Forms of Doing Business

Corporations are now told to endure five fixed annual taxes — the normal, surtax, excess profits, capital stock, and declared value profits tax. They are also liable to the section 102 buzzard when they least expect it, to payroll taxes on stockholders' compensation and to stamp taxes on the transfer of ownership in their equities.

An illustration of the savings possible by transfer of the corporation assets to partnerships is given in the following example:

Example

Annual corporation taxes (assuming that sufficient capital stock taxes are paid to eliminate declared value excess-profits taxes; that the entire net income (before specific exemptions) is subject to excess profits tax, that the net income reflects a $10,000.00 salary to each officer stockholder each owning 50% of the stock; and that 70% of the net income after all taxes is distributed as a dividend) compared to those payable by two married individuals operating as a partnership with no dependents and no income other than that received from the business.

With Net Income (after Salaries) of	Total Capital Stock, Normal Surtax and Excess Profits Tax	Taxes Paid by Two Officer-Stockholders	Total Corporate and Individual Taxes	Taxes Paid by Two Individuals in Partnership	Net Savings in Tax by Operating as a Partnership
$ 5,000	$ 1,112	$ 3,290	$ 4,402	$ 3,996	$ 406
15,000	6,233	4,270	10,503	7,332	3,171
20,000	8,793	4,799	13,592	9,308	4,284
25,000	11,353	5,363	16,716	11,464	5,252
50,000	26,895	7,738	34,633	23,924	10,709
100,000	59,083	13,108	72,191	53,034	19,157
150,000	92,285	18,914	111,199	85,138	26,061
200,000	125,660	25,001	150,661	119,178	31,483

Presented at the November 17, 1941 meeting on Federal Taxation of The New York State Society of Certified Public Accountants.

The saving is not always secured to the partnership. It may well be more costly under another statement of facts, particularly if there is less than 70% in dividends, or if there is no problem in the allowance of the deduction for officers' salaries. But each case requires only full use of a pencil, some paper and the rate schedules to find where you stand.

Add now the burden of the proposed 100% tax on all profits over 6% of invested capital or the more recent suggestion of a revival of the undistributed profits tax or the Treasury proposals for a very high payroll tax on all, including officer-stockholders, and we find a comfortless, melancholy future for corporate ownership.

On the other hand, partnerships and proprietorships often have a relatively refreshing and inviting prospect because of the mathematical advantage.

Certainly, the bait is a bewitching inspiration to incite our whole list of clients to accept the subsidy. Sometimes that is possible, particularly in corporations with a small group of stockholders—in others, personal liabilities, infant stockholders and other conditions present insurmountable problems.

Assume now that we have hurdled the legal obstacles and like the idea of conversion to the favored side, what are our tax problems?

First our assets must be transferred to the stockholders. Shall we liquidate or are there other methods? Perhaps we might find a decided tax advantage in a dividend in kind of a substantial block of our assets. That may depend upon the stockholders' income.

Or, perhaps we would rather have stockholders buy part of the assets at their fair value in order to avoid any tax to them in setting up the partnership, even if that produces a gain or loss to the corporation.

Or, perhaps a rental of assets to a stockholder partnership can be proved to have been a proper step.

Or, possibly we can so arrange our stockholdings and business so that we can plead that our corporation, or at least part of what remains, is a personal service company and is to be treated like a partnership for the excess profits tax.

All of these have their place in the review of each problem.

But assume now that we find that liquidation is the only hope. We have got to recognize that the stockholders may have to pay a tax upon the receipt of the assets they use to form a partnership. Sometimes, that is cheap in the light of the benefits. The law still permits you to elect a complete liquidation so that if stock has been owned for more than 18 months, the gain is long term capital gain. And if the stock has been held for more than 24 months, the total tax paid by stockholders for their share of the booty cannot be over 15% (not 16½% this year) of the gain so realized. If the liquidation results in a loss, then it is treated as a capital loss.

Or you may elect a liquidation in which all assets are distributed within three years after the close of the year after the formal plan for liquidation is adopted. And thus, you spread the tax over three periods. To do that you must be optimistic enough to believe that the capital gains tax will stay at the present bargain rates for the next three years.

There are a lot of other notes to make as you study this problem. Some of them are so important that they may actually encourage liquidation when the idea never otherwise appeals. Others will wreck the best kind of mathematics that approve the conversion. For instance—

1. An enormous advantage is offered in a stepped up basis at bargain rates. If stockholders take assets at fair market value

and pay only 15% to get new values, it is obvious that immediate deductions at much higher rates are available. That may be particularly helpful if inventories have risen. The corporation might have to pay a 70% tax over cost when they are sold, but the stockholder gets the right to sell them free of tax by paying 15% of fair value in liquidation. The same step may radically increase depreciation and also the basis of capital assets held for disposal. But of course there may also be a step down in a liquidation if inventory and other assets are worth less than the cost basis to the corporation.

2. Partnerships get an advantage over corporations in their deduction for contributions and in the handling of tax free interest. The partners can deduct their share of partnership contributions at the 15% rule while corporations are limited to 5%. They can also take their share of the tax free interest as exempt income instead of as taxable corporate distributions.
3. Partnership long-term capital gains are taxed only at 15% to 20% while corporations pay the full normal and surtax on them. On the other hand, partnerships get less allowance for capital losses.
4. Partnerships cannot take the new amortization deduction. For some reason it is confined to corporations.

And if you decide to liquidate—when shall you do it? It requires a lot of study. Perhaps these notes will start you off in your problem.

1. Do you have a net loss carry over? Obviously liquidation will eliminate it and that might be costly. Shall you wait until you have used up all of the carry over? Or will they change the law before you get any benefit out of the intended relief!
2. Is this the right year to liquidate from the stockholder's standpoint? Is this or some other time the period when he may have an offset to the gain in liquidation. Or if you wait, how can you be sure that the present capital gains rates will hold for another year?

We ought not to leave even so brief a discussion of this subject without the caution that the law insists that partnerships will be taxed as corporations if they have the characteristics of corporations. We must be ready to prove that our partnership structure can be interrupted by a change in ownership of a participating member or by a death of a member; that management is not centralized into a body similar to a Board of Directors; that the partners have assumed the burden of personal liability.

But since so many of our corporations are conducted exactly like partnerships, rather than visa versa, we should have little trouble on that score.

If you do liquidate remember that you must file Form 966.

2. Concentration of Assets in One Corporation vs. Division

If you must continue your corporation, what about dividing it? While it is a fact that the excess profits tax law pretty much bars the division of companies in order to get any material profits tax advantage, dismemberment is still a gainful occupation in a lot of cases. First, the highest bracket rule in the excess profits tax does not seem to prevent each new link in a split-up from getting its $5,000.00 exemption. But more important, is the fact that normal tax rates are materially lower

below $25,000.00 than they are above that figure.

We therefore, get a mathematical advantage to companies where earnings are held below the $25,000.00. That is impossible under many conditions, and yet it does often make expedient division of companies in order to gain the advantage of normal tax savings, even though the profits tax saving is confined to the extra $5,000.00 exemption.

The following tables illustrate the effect of the division of a corporation into smaller units—

Federal Tax Rates after Division into Several Units
Assuming no Excess Profits Tax Is Payable

If the Net Income Is	Then the Total Taxes* Will Be	But if We Divide Into 2 Corporations	4 Corporations	8 Corporations
		Then the Taxes* Would Be		
$ 20,000	22.50%	22.00%	21.00%	21.00%
40,000	30.37	22.50	22.00	21.00
50,000	30.50	23.00	22.20	21.40
80,000	30.69	30.37	22.50	22.00
100,000	30.75	30.50	23.00	22.20
120,000	30.79	30.58	26.50	22.33
140,000	30.82	30.64	29.00	22.43
160,000	30.84	30 69	30.37	22.50
180,000	30.86	30.72	30.44	22.78
200,000	30.88	30.75	30.50	23.00

* Normal and Surtax.

Federal Tax Rates after Division into Several Units
Assuming an Excess Profits Tax

(The following calculations assume that the excess profits credit is zero, the income used is subject to Excess Profits taxes and is stated before the $5,000 specific exemption.)

If Income Subject to Excess Profits Tax Is	The Total Taxes* Will Be	But if We Divide Into 2 Corporations	4 Corporations	8 Corporations
		Then the Total Taxes* Would Be		
$ 20,000	42.71%	35.48%	21.00%	21.00%
40,000	49.07	43.67	35.47	21.00
50,000	52.54	45.70	39.14	26.79
80,000	56.78	50.47	45.12	36.43
100,000	57.83	54.22	47.63	40.30
120,000	58.97	56.95	49.30	43.19
140,000	59.90	58.49	51.16	45.25
160,000	60.60	59.37	52.58	47.28
180,000	61.14	60.05	54.58	48.86
200,000	61.58	60.59	56.32	50.13

* Normal, Surtax and Excess Profits Tax.

How do we get the economy of the lower brackets? What whittling can be accomplished without tax to the corporation or its stockholders, or what tax ought the controlling groups be anxious to pay in order to get a split of activities? Some kinds of transfers probably take us out of the highest bracket rule and give us the full advantage of division—particularly, real purchases of a company's assets by the stockholders, taxable dividends in kind to stockholders, cash dividends that are used

by them to fairly acquire assets then conveyed to a new company.

All of these also give us the normal tax advantages of the graduated brackets.

And if the job of division is too tough, we have at least learned that we want a lot of little companies in this era. The big ones are social outcasts.

3. Ownership of One Kind of Asset vs. Another

Most of us have an irrevocable choice as to the company we keep and the color of the paint upon our house. Similarly we may elect to keep our assets, sell, or abandon them as we choose. And as tax advisors, we have an obligation to constantly review the assets of our clients so as to politely suggest those to be regarded with disfavor and those where current laws give opportunities for loss deductions.

We still have a capital gains tax. Current pressure for new taxes could easily sweep present arrangements out the door. Note this of corporations—

1. Losses on sales of depreciable property, whether long or short term, are fully deductible for all kinds of taxes.
2. Losses on the sales of capital property held for more than 18 months are still fully deductible for the normal and surtax, even if they are not considered in computing the excess profits tax. They may even fully eliminate the normal and surtax liability. Why should we hold on to them in the face of a possible change in our statute?

And there are other factors that should have your consideration as you ponder the options as to capital assets. Non-dividend paying stocks are inadmissible assets. They reduce invested capital and cause no end of headaches to clients. It seems unjust, but that is the case. One alternative is the disposal of the asset.

My observation is that we are particularly overburdened with such anchors in inactive or unprofitable subsidiary companies. Possibly another method of relief is a conversion of these stocks into bonds. They are not inadmissibles.

What about losses that can come with abandonment of property of no further use or where income probabilities are not comparable with the deduction that might be had this year? The limitations on the sale of capital assets have no application to these. Abandonment losses are deductible in full.

Under the present law, depreciable assets used in a business, such as machinery, furniture, etc. are not "capital assets." Therefore, it is advisable to sell the asset at its salvage value, rather than claim the loss resulting from abandonment. This is so since the loss on the sale is deductible in full. Moreover, you get your salvage value and definitely fix the time of the loss.

While talking of abandonments it is interesting to note that the courts have allowed a loss for abandonment of real estate, where the owner proved that he had definitely decided to abandon the property and toward that end had offered a deed or assignment of rent to the mortgagee.

Other cases suggest that this type of abandonment loss is limited to instances in which there is no personal obligation on the mortgage bond. A loss for abandonment has been permitted when the owner, although financially able to do so, refused to pay taxes, interest on mortgages, or to make necessary repairs. Such losses have been allowed even prior to actual foreclosure.

In another case, a loss on securities resulting from default in paying an assessment against stockholders

was approved as a full loss rather than a limited capital loss.

While it is a little off the path, let me note a couple of other tax saving ideas.

Of course, if you sell land and buildings, you know, I hope, that it is often most advisable to have the sales price split-up between the amount paid for the land and the amount paid for the building—so as to get the greatest economy. The land is a capital asset and the building may not be a capital asset.

And then you ought to know that—

If we own land and a building and think we can sell the land only after demolishing the building for at least the same price as can be secured for both, that sometimes tax economies may be possible by razing the building despite the cost of clearing the land. Sale of land gives a capital gain or loss—while sale of a building used in a trade or business secures an ordinary gain or loss, taxable or deductible in full. Demolishing the building will give you a loss (depreciated cost) upon its abandonment and sale of the cleared land will give you a capital gain or loss subject to the limitations. Which way you operate will depend upon the result of the calculations. But if you raze the building prior to the sale, the cost of the building is not included in your basis, since it is not a part of the property sold.

And one last word about disposal of business assets—

A trade-in of property used in a business when repurchasing new property of a similar character does not give us gain or loss. If the trade-in allowance is actually less than the depreciated cost of an old truck, then in order to obtain a deduction or loss that would be recognized, we can, in two separate and distinct transactions, sell the old truck for cash and then purchase the new truck.

4. One Kind of Financing as Against Another—Particularly Interest vs. Dividends

The discrimination in our tax statutes against financing by stock has received considerable public notice lately in the suggestion that the SEC would like to find some way to avoid top heavy debt structures before we get into the post war era. Perhaps we shall get a change out of Congress, but as we now stand, interest is deductible and dividends can only be met if there are net profits after taxes.

Today's tax rates accentuate the need to convert a great deal of our stock into issues that will permit deductible interest payments.

Of course, that can be done without tax to the holders when their basis is as great or greater than the proposed face amount of the obligations to be issued to them or by tax free reorganizations and recapitalizations. Where these steps are not possible, you again get out your pencil, paper and the rate tables to find whether it will be to your advantage to convert in order to obtain the corporate deduction, when capital gains may be taxed at only 15%.

For example:

If your stockholder paid $800.00 for his stock held over 2 years, and you want to deliver a $1,000 bond to him in a conversion, his tax will be $30 at capital gain rates. Your interest of say, $50 will be fully deductible to your corporation and the stockholder is fairly sure to recoup his tax outlay in one year. But if a corporation is paying 50% in taxes, its annual payment of $50 might only be $25 because of the $25 tax, and the stockholder may be out of pocket in a couple of years.

On the corporation's side it is important to note that we have been given a new advantage in our study of conversions by the reduced cost of interest. The effective rate of interest under current tax laws when there is an excess profits tax is illustrated by the following tables—

Net Cost of Borrowing Money if a Corporation is Subject to Excess Profits Taxes

If a Company Uses the "Invested Capital Credit"

If Rates of Interest Paid on Borrowed Capital Are	Actual Rate of Interest on the Following Excess Profits Tax Brackets 35%	40%	45%	50%	55%	60%
1 %	— .39675 %*	— .552%*	— .70725 %*	— .8625 %*	—1.01775 %*	—1.173 %*
1½%	— .112125%*	— .276%*	— .439875%*	— .60375%*	— .767625%*	— .9315%*
2 %	.1725 %	0	— .1725 %*	— .345 %*	— .5175 %*	— .69 %*
2½%	.457125%	.276%	.094875%	— .08625%*	— .267375%*	— .4485%*
3 %	.74175 %	.552%	.36225 %	.1725 %	— .01725 %*	— .207 %*
3½%	1.026375%	.828%	.629625%	.43125%	.232875%	.0345%
4 %	1.311 %	1.104%	.897 %	.69 %	.483 %	.276 %
4½%	1.595625%	1.38 %	1.164375%	.94875%	.733125%	.5175%
5 %	1.88025 %	1.656%	1.43175 %	1.2075 %	.98325 %	.759 %
5½%	2.164875%	1.932%	1.699125%	1.46625%	1.233375%	1.0005%
6 %	2.4495 %	2.208%	1.9665 %	1.725 %	1.4835 %	1.242 %

If a Company Uses the "Income Credit"

If Rates of Interest Paid on Borrowed Capital Are	35%	40%	45%	50%	55%	60%
1 %	.4485 %	.414%	.3795 %	.345 %	.3105 %	.276 %
1½%	.67275 %	.621%	.56925 %	.5175 %	.46575 %	.414 %
2 %	.897 %	.828%	.759 %	.69 %	.621 %	.552 %
2½%	1.12125 %	1.035%	.94875 %	.8625 %	.77625 %	.69 %
3 %	1.3455 %	1.242%	1.1385 %	1.035 %	.9315 %	.828 %
3½%	1.56975 %	1.449%	1.32825 %	1.2075 %	1.08675 %	.966 %
4 %	1.794 %	1.656%	1.518 %	1.38 %	1.242 %	1.104 %
4½%	2.01825 %	1.863%	1.70775 %	1.5525 %	1.39725 %	1.242 %
5 %	2.2425 %	2.07 %	1.8975 %	1.725 %	1.5525 %	1.38 %
5½%	2.46675 %	2.277%	2.08725 %	1.8975 %	1.70775 %	1.518 %
6 %	2.691 %	2.484%	2.277 %	2.07 %	1.863 %	1.656 %

Asterisks denote tax saved is in excess of the interest cost.

All of these examples assume that a company is also subject to the 24% Normal Tax and 6% and 7% Surtax, and that it has a total invested capital of $5,000,000 or less.

Of course, conversions may reduce equity invested capital and these tables only show the true cost of interest. You need your pencil and paper again.

And note, too, that something is said in the regulations about our inability to borrow money merely to increase borrowed capital, but I remember nothing that says that we may not borrow when we actually decrease invested capital or seek to get the interest deduction.

Study of the advantages of conversions into interest bearing obligations is highly essential in light of the proposal of the Secretary of the Treasury that all profits in excess of 6% of invested capital be recaptured. If we have to pay everything in taxes, how are a lot of companies going to pay dividends, particularly if they have existing obligations or redemptions. But if they have debts to old stockholders, there is more hope for some annual return.

We sometimes meet the objection that a fixed obligation for interest is inadvisable. It would be too burdensome in hard times. Sometimes we can still get our deduction by converting stock issues into debentures in which the interest varies with the income or is contingent upon other factors that might avoid a default in difficult times.

5. Purchase of More Happily Circumstanced Companies vs. Ventures in New Companies

One of the most difficult alternatives in the tax laws is that available to purchasers of entire companies. We have lived long in an accounting atmosphere which advises the purchase of assets in a company rather than its stock, simply because we have feared the assumption of unrecorded debt. And yet, present tax laws suggest that there is often far more to be gained by acquiring stock.

Naturally, when we buy stock, the basis for depreciating the corporate assets does not change. Sometimes that is much better than the basis obtainable by purchasing the individual assets.

Then we may like the company's net operating loss carry-over a great deal, particularly if we own a profitable business that can be merged into it.

Or if the company has large obligations which the corporation acquires at a discount, we are still entitled to use them at their full basis for borrowed capital and deductible interest, regardless of the price we paid for them. In many cases we can contribute them to increase invested capital.

Sometimes, too, we get very substantial advantages in computing the income credit for the profits tax by following the statute's process for use of predecessors' earnings in the base period.

The moral, then, is that we must look way beyond the audit of assets and liabilities to get the full advantage of the law.

6. Use of Proper Fiscal Year vs. Calendar Year for Reporting

At this stage, let me steal Jack Seidman's eloquent plea for a "Natural Tax Year." Our calendar year and natural business year reporting have gotten us into all sorts of tax problems that could have been readily avoided by recognition of the practical fact that our new tax laws are always passed long after most of our companies have started their new year. I do not need to recite here the advantages to those companies whose fiscal years ended after August 1941. As an example, read the provisions involving new capital in the September profits tax amendments. In the interest of lower taxes for our clients, we probably ought to urge the change of fiscal years to an October basis—keeping our trained eye on the annualizing process in the excess profits tax law. Certainly reporting for late fiscal years would also give us a tremendous advantage with capital stock taxes since we would place valuations when we had a much better knowledge of earnings.

Fiscal years ought to be set, too, with due recognition of the pugnaciousness of section 102. We sometimes can do much to avoid its surliness, if our balance sheet is at a date which shows our greatest possible investment in working assets other than cash and the fullest extent of the loans necessary to finance a business.

And while on the subject of fiscal years—note this: One of the unusual opportunities present in the change from the corporate to the partnership form is the right to choose a new fiscal year. Apparently new partnerships can create any year they choose.

As an example, we seem to be able to postpone into succeeding stockholders' reporting periods 11/12ths of any income produced in the first year of conversion from a corporation to a partnership. The same would be true of any new partnership. Unlike corporations, partnerships also get the advantage of being able to set up a new fiscal year with the admission of new partners.

All these are effective methods of deferring income into later years for

the partners or splitting income in years of large earnings in the case of companies whose income is large one year and small in another. They do that, of course, in the hope that the process will not catch up with them and result in higher taxes at the end of the line.

7. Old Inventory Method vs. Last-in, First-out

Here now is the first year since the "Last-in—First-out" rule was issued that prices of practically all clients inventories are materially up. Shall we use the new device in 1941 closings? Under it, you know, our closing inventories, now held and which were also in the opening picture, can be priced at the opening inventories average cost of the materials. All sales in 1941 are costed at the highest possible figure. And the Treasury has brought to our attention the fact that we may use this method for any part of the inventory—any part of the raw stock, work in process or finished stock. We hear much of its value as an aid to eliminating inventory inflation in rising markets and the advantages of its use to cushion against severe losses in post war declines. Since current sales are priced at current purchases, it is argued that in a period of this kind, it permits fair reflection of profits when they are really earned. We hold the opening inventory at the same value despite price fluctuations and vary it only with a physical change. Therefore, it is suggested we more properly state the effectiveness of business by removing all fluctuations due to the market conditions. And incidentally, we pay the lowest possible tax on sales of inventoried goods.

Of course we will hear a lot of other arguments about the need for better devices when prices drop.

At any rate, we have an unusual situation that should be carefully studied this year, particularly if we can get our clients to regard the savings as a reserve against the blow in a later year.

8. Ordinary Compensation Plans vs. Deferred Payment Arrangements

Turn now to the very important question of how to postpone compensation to the mutual tax advantage of both employer and employee in this era of extremely high personal taxes. A deferment is often an opportunity to hold a man on his job despite other offers that secure immediate pay at high tax rates.

Of course, all plans to defer compensations (other than the creation of an actuarially sound pension trust advocated so much in the literature of insurance companies) carry this insistence—any amount paid or set aside for an employee or officer, plus his regular salary must not exceed a "reasonable compensation" or else we cannot get a deduction in corporate returns. What is "reasonable?" It still seems to be the sum you would have to pay to replace the employee, bearing in mind his experience, education, intelligence and many other personal attributes.

What plans can you consider? Here are a couple that seem to be approved by the cases—

1. If you are sure that increased earnings or inflation are coming, give officers or employees options to buy your stock at present values. If they later exercise the option (when the stock is worth more) the appreciated values may not be income. I say "may not' advisedly because the Board last month ruled that the difference between the option price and the market price at the time the option was exercised, was compensation; this even though the stock acquired was not resold.

2. Set aside a specific sum payable to a group of officers and employees in a specific number of years provided they perform some definite act under their control—for instance, stay as an active employee with your business until the end of a five year period. Such sums cannot ever be returnable to the company. If one officer or employee happens not to complete his agreement, his share might go to the others. Under these plans, you seem to get the corporate deduction when you create a trust setting the money apart and the employee pays his tax in the year when he gets his money. Of course, the contingency described by the contract must be real.
3. Create real pension trusts (not necessarily on an actuarial basis) by setting aside a sum this year and putting up any other money when you choose to do it. Under these the employee takes down his share at a given age if he has lived up to his part of the contract. If he has not, the fund is split among the others, but it is never returnable to the company. The employee pays his tax when he gets his funds. Thus, if the trust provided for deferred annual payments, each annual installment will be taxed in the year of receipt. It ought not to be necessary to add that these plans should not be designed to save taxes for a couple of stockholders who are insiders. That device probably will not work.

9. Elections in Deductions for Interest vs. Ordinary Rules

First, if we report on a cash basis, it is pretty definite now that we are not entitled to deductions for interest unless payment is actually made. And yet, the rule makes for positive tax control. A payment in the form of a promissory note is not sufficient to permit the deduction. Nor will the mere increasing of the loan or note by the amount of interest owed, as is usually done in the case of insurance loans or brokerage accounts, insure the deduction. If you need it, you must pay for it even if you elect to borrow the necessary funds. The rule may be irritating, but it also has its cheerful side in the option secured for those choosing to prepay or defer payment.

We get the same type of cheer in the control of interest income and deductions between debtors and creditors because the payment can readily be regulated by agreement. Whether payments are against either principal or interest can be indicated at will, in order to obtain the greatest benefit. Where no agreement is made, a payment is first used to liquidate interest owed. To illustrate: If you receive a partial payment on an interest bearing debt, and the payer does not need a deduction for interest paid, you may elect between you that the partial payment is to be applied only to principal. In this way, you will avoid a tax on interest income.

Or we can control interest income or deductions when we buy and sell by adjusting our price to obtain the greatest tax benefits. When deferred or installment payments are involved, it may be highly advantageous to increase the selling price rather than receive yearly interest. Although the buyer would lose a deduction, the seller, if selling at a loss, would reduce the loss but would not have subsequent interest income when rates might be higher. Or if a capital asset is sold at a profit, the recognizable gain might be reduced by the rates applicable to long-term holdings. When the item sold is depreciable property, there is an additional control possibility. A flat price of $12,000.00

for the asset would enable a purchaser to take, say, $1,200.00 a year for 10 years as depreciation. A price of $10,000.00 payable in 4 equal installments with $500.00 per year interest would give the purchaser a $1,500.00 deduction for the first 4 years, and $1,000.00 for the next 6 years.

10. Other Problems in the Law and Cases vs. Accounting Assumptions of Income or Expense Prepayments, Advance Deposits and Rentals

My last note in this summary of alternatives suggests that we have a broad job to watch tax trends that take us far from accounting concepts of income.

For example, we must attempt to understand the economies incident to the rules that unrestricted advance payments, deposits, and rentals are income even though you report on the accrual basis and may require expenses before we, as accountants, would term them real income. A recent case involving a prepayment on a contract for advertising found the Board calling it income in spite of the fact that services had to be rendered and expenses paid to earn the money in later years. If application of the principle to other unrestricted prepayments is not far off, then we seem to have a new way to get income into the year of our own choosing. Certainly we would look for income in years of increasing rates or in loss years, for their judicious inclusion will take income from otherwise higher taxed years.

Here, incidentally, is another argument for the natural tax year. If we were certain rates were up for the next period, we might scout the bushes for advance income, even if we had to pay a liberal cash discount to get it.

Another opportunity is in claims that income from recoveries of the items deducted in a loss year are not now taxable. Several recent cases strengthen this position that such recoveries reduce the amount of the original loss and are not income if no tax benefit was derived. For example, where a corporation deducted a capital loss, leaving a net loss for the year, a partial recovery of the capital loss in a later year was held not taxable where it was less than the reported loss when deducted. Again, where an officer cancelled an unpaid salary deducted in a loss year, there was no income; taxes deducted in a loss year were held not to be income when cancelled or recovered later. The exclusion from income of these items has been permitted by the Board against the efforts of the Treasury to disallow them. We seem to have reasonable authority to label all of these adjustments of prior years' deductions as non-taxable.

* * * *

This, then, is a summary of alternatives and possibilities in the Code and decisions. They apply today. Tomorrow they may be no more, and all our tax intelligence repealed. So it goes in taxes. I hope, however, that the material we have covered will effectively see us through at least 1941.

Some Questions and Answers on Federal Taxation

By The Committee on Federal Taxation
New York State Society of Certified Public Accountants

Some of the many interesting questions presented by members in connection with the meeting on Federal Income Taxation which was held at the Waldorf-Astoria Hotel on November 17, 1941 are considered to be of sufficient general importance to warrant their reproduction for the benefit of all the members.

These answers must be regarded as an expression of personal opinions by members of the Committee on Federal Taxation, and are not to be construed as representing an official opinion on the part of the Society as a whole.

Question: A corporation was insolvent at the beginning and end of its taxable year (1939-1940). During the taxable year it purchased a small lot of its second mortgage bonds at a discount. It credited the discount to its very large deficit account which still showed a large deficit balance. Regulations 103 on Section 22-(B)(9) states that income from discharge of indebtedness shall not result in taxable income. The corporation failed to attach to the tax return form 982 as required (See Sec. 19.22 (B)(9) -2- page 53 of Regulations 103). The Internal Revenue agent now proposes to assess the tax on the discount because form 982 was not attached to the return at the time of filing. We have agreed to file the form 982 now. It was refused as not being timely. Must the corporation be penalized merely for not attaching form 982 to the return?

Answer: The question illustrates the need for conformity with the regulations in seeking relief from taxation on an item representing income taxed under a general rule. Applicability of section 22(b)(9) requires filing by the taxpayer of a return "in such manner as the Commissioner prescribes by regulation." The regulations require filing of a consent with the tax return. Since this was not done, relief under the section appears unavailable.

However there appears to be reasonable doubt in this case of classification of the transaction as income at all. The Board of Tax Appeals has ruled that income from cancellation of indebtedness cannot exceed the amount of solvency after the cancellation. Since this taxpayer is stated to be insolvent after the transaction no income was received, and no tax due since the Congress can tax only income, under the income tax statutes.

Question: In 1932 the underlying collateral on a bank note had been sold by the bank resulting in a loss to the taxpayer of over $1,000,000. After applying the proceeds from the sale of this collateral, which consisted entirely of securities, a balance of approximately $50,000 was still owing to the bank.

During the year 1941 the balance due the bank was finally settled for a cash payment to the bank of $40,000, resulting in $10,000 income from the discharge of this indebtedness.

The taxpayer feels that since he has suffered such a tremendous loss from the forced sale of the collateral at the depressed prices in 1932, he

should not have to pay any tax on the $10,000 income resulting from the cancellation of the indebtedness. No taxable benefit resulted in 1932 on the $10,000 now cancelled as the loss resulting from the forced sale of securities was far in excess of taxable income during that year.

Considering the fact that the taxpayer has an earned surplus (deficit) account of approximately $1,000,000, it may be possible that this $10,000 can be eliminated from taxable income in the year 1941 under Code Section 22 (B)(9).

Is this item tax exempt under 22 (B)(9) or has the Commissioner any further discretionary powers to consider this a tax exempt item in view of the tremendous loss incurred in the sale of the underlying securities supporting this bank note payable?

Answer: The 1932 loss is not pertinent to the 1941 tax situation. Nor is there any way by which the Commissioner can give consideration to the 1932 situation now.

If there was an enforceable obligation of $50,000 in 1941 section 22 (b)(9) may be applicable since a note in existence on June 1, 1939 is a security as defined in that section. It will be necessary to establish to the satisfaction of the Commissioner that an unsound financial condition existed prior to the cancellation. The amount of deficit is not significant if assets exceed liabilities. However section 22 (b)(9) does not require that liabilities exceed the fair market value of assets, or that the taxpayer be unable to meet current obligations as they mature. If the bank agreed to the partial cancellation because of doubt as to ability to collect, the section would appear to be applicable. Since the law requires satisfaction of the Commissioner, facts should be presented to him, and if relief is denied the transaction examined in the light of the reasons given for the denial.

Question: A taxpayer who conducted a business as an individual until in 1940 was required by creditors to incorporate, so that they could hold the stock as security until debts were paid. In 1941 another agreement was reached permitting return to business operations as an individual. Can the existence of the corporation be ignored and individual returns filed for all periods as if the corporation had never existed?

Answer: A corporation is legally distinct from its stockholders, and in the absence of fraud its separate transactions will not be ignored for tax purposes.

If the corporate form is availed for purposes of evading taxes, or as a sham and a subterfuge, there is abundant authority for ignoring it, or at least for assessment of the tax in the amount which would be due if no corporation existed. However, if the existence of a corporation results in an increase of tax, there is no basis by which the payment of corporate taxes, filing of returns, etc. may be avoided. Liability for corporate taxes and returns was part of the cost of the settlement reached with creditors.

Question: On February 1, 1940 A purchased all the merchandise and accounts receivable of the D Corporation at a receiver's sale for $8,500.00 cash. At that time the court's appraiser valued the merchandise at $3,000.00 and no value was set for the accounts receivable which aggregated $10,500.00 of actual customers balances for merchandise sold prior to the receivership. A received a bill of sale for the items and he then formed the A corporation and transferred these assets to said new corporation for 100 shares of no par stock at a stated value of $25 per share or a total of $2,500.00. The accountant who opened the books of the corporation conformed to the minutes

which directed that $3,000 for merchandise and $10,500.00 for accounts receivable be set up as assets and $2,500.00 be set as capital and $11,000.00 as donated surplus. At the end of the first taxable year, December 31, 1940, $4,500.00 of the customers accounts were fully collected. A total of $2,000.00 was deemed bad and uncollectible after the company was unsuccessful in legal proceedings in trying to collect same. The corporation kept its records on the accrual basis and the said $2,000.00 was charged off against donated surplus.

Question (1) What amount if any should have been reported as taxable income for year 1940 received by either A or the A Corporation?

(2) Suppose the balance of $4000. of accounts were collected during 1941 what amount would then be reported as income for that year?

(3) Would the result be any different if the Corporation was on a cash basis rather than on the accrual basis?

Answer: (1) Mr. A. acquired $10,500.00 worth of accounts receivable for a cost of only $5,500.00. Where accounts receivable are purchased for less than face value, profit is realized on collections made to the extent of that part of each payment equal to the ratio between the total discount value and the face value of the accounts acquired. Thus whoever is liable for the tax would have to ordinarily report as income $\frac{5,000}{10,500}$ or about 47.6% of the $4,500.00 collected or $2,142.00. However, here it is obvious that $2,000.00 worth of accounts were really valueless and therefore Mr. A. purchased the accounts at a discount of $3,000.00 and not $5,000.00 and the income reportable would be $\frac{3,000}{10,500}$ or about 35.3% or $1,588.00. The income would have to be reported by the Corporation and not Mr. A (See Secs. 111(b) 5 and 113(a) 8 of I.R.C.)

(2) The balance of the $3,000.00 discount or $1,412.00 would have to be reported as income by the corporation for 1941.

(3) No difference here whether corporation on cash or accrual basis.

Question: If a holder of common stock receives rights to subscribe to preferred stock convertible into common stock, does the receipt of the rights constitute taxable income? If so, when?

Answer: In a decision handed down by the Supreme Court (*Palmer v. Commissioner,* 302 U. S. 63 reversing this issue 88 F. (2d) 559), it was held that rights given to stockholders to subscribe to stock of another corporation, did not constitute taxable income. In the Palmer case the court stated that the issuance of rights to a stockholder to subscribe to stock and the receipt of such rights by a stockholder could not result in a dividend, but that taxable income might result if such rights were sold. The court stated that if the corporation had made a distribution it could not be held to have been made until the stockholder exercised the rights.

The Treasury has been taxing the recipients of such rights. The Treasury's position seems to have been inconsistent in these cases in view of the Treasury ruling (G. C. M. 13275; C. B. XIII-2, p. 121) that rights given to a stockholder to subscribe to bonds convertible into stock did not constitute taxable income at the time of receipt.

In a recent decision, the Board (*Gibson,* 44 B.T.A. No. 146) held such rights taxable. Six members dissented. The arguments on both sides are given in the majority and minority opinions.

Code Section 115(f) provides that a dividend in stock or rights which constitutes income under the Sixteenth Amendment shall be treated as a dividend. The law does not pro-

vide a rule for determining under what circumstances the stock or rights constitute taxable income. The decisions are to the effect that if a dividend in *stock* gives a stockholder an interest different from that which he had previous to the dividend, such dividend will be taxable. It may be inferred that if any rights can constitute taxable income, they would have to give a right to subscribe to stock which would be income if issued as a dividend. Until the matter is more definitely settled, the stockholder would be justified in excluding a value for the rights received, but making a disclosure in the return. This would avoid any suggestion of negligence on the part of the taxpayer in the event it should be held that such rights are taxable under the law.

Question: A received a gift of stock in January 1941 which was worth $100,000 at that time. The donor purchased this stock in 1930 for $100,000. A sold the stock in November 1941 for $80,000. This is less than a year since A acquired it but more than 10 years since the donor purchased it. Is the loss short term or long term?

Answer: It is apparent from the question that A has a loss from sale of the stock whether the basis applicable is the cost to the donor or fair market value in January 1941, the date of the gift. Sec. 113(a)(2), I.R.C., provides that where property was acquired by gift after December 31, 1920 the basis in the hands of the donee for the purpose of determining loss shall be the basis in the hands of the donor (if the donor did not also acquire it by gift) or the fair market value of the property at the date of the gift, whichever is lower.

If the basis to be used is the basis to the donor the period for which A has held the stock is to include the period for which the stock was held by the donor. See Sec. 117(h)(2), I.R.C. In this case the loss would be a long term capital loss because the donor acquired the stock in 1930.

If the basis to be used is the fair market value at the date of the gift it is held in I.T. 3453, 1941 I.R.B. No. 9, page 6, that the donee will be considered as having held the property only from the date of the gift. In this case the loss would be a short term capital loss because the sale was made within 18 months after the date of the gift.

The primary basis for property acquired by gift is its basis to the donor. The use of market value at date of gift as a basis for determining loss is made an exception to the primary rule. The phrase "whichever is lower" does not apply here because neither basis is lower. It seems reasonable to assume that since the primary basis is the cost to the donor, the donor's basis would apply unless the market value at date of gift were lower.

It will be noted the wording of this Sec. 113(a)(2) differs from that of Sec. 113(a)(14). The latter section provides that the March 1, 1913 value is to be used for determining gain if the basis otherwise determined is less than the March 1, 1913 value. Under this provision if the cost and March 1, 1913 value were identical, it would be the cost which would be used, since it is not less than the March 1, 1913 value. If similar wording had been used in Sec. 113(a)(2), it could have been made clear that the donor's basis should be used for determining loss except where the market value at date of gift was less. The fact that a different wording was used raises the question of whether the same conclusion would apply. Perhaps the answer is to be found in the fact that there would usually be enough margin in determining value at date of gift so that it could be determined as

either slightly more or slightly less than the donor's basis, and so the question of legal interpretation in a case where the two bases were identical would be avoided. The taxpayer presumably would wish to choose either the long term or short term loss basis whichever would be more beneficial whereas the Treasury might naturally be inclined to take the opposite position.

Question: A Corporation secured a refund during the current year of real estate taxes paid during the past ten years and allowed as deductions on Federal income tax returns. How should the amount of the refund be reported for income tax purposes?

Answer: When real estate taxes have been paid for a number of years and allowed as deductions in computing taxable income for the years in which they were paid or accrued, the treatment of refunds received in a subsequent year after successful litigation depends upon whether the years in which the deductions were taken are still open for assessment of additional income tax. As to any years for which assessment is not barred by any law or rule of law, such as the statute of limitations, the tax liability should be adjusted by correcting the deductions previously taken. The refunds received which are attributable to years for which assessment is barred should be included in taxable income in the year received, or in the year in which the right to the refunds becomes final, depending upon whether income is reported on the cash receipts or the accrual method. This rule, allowing open years to be adjusted, was followed in the recent Board of Tax Appeals case, *The E. B. Elliott Co.*, 45 B.T.A. No. 16.

There are, however, many questions as to the nature of the proceedings and decision leading to a refund and as to possible differences of thought by the Bureau, the Board of Tax Appeals and the courts in different cases, so it is not possible to rely on every case falling under this rule.

Question: A foreign corporation doing business in the United States took out insurance in London against the collection by the United States of unjust enrichment taxes. In 1941 it paid $100,000 of such taxes and was reimbursed by the underwriters. Should the corporation include the reimbursement in gross income?

Answer: It is questionable whether this reimbursement is includible in the gross income of any corporation for Federal income tax purposes. The general provisions of Sec. 22, I.R.C., do not mention insurance reimbursements for losses or expenses. There are specific provisions excluding from gross income, under Sec. 22(b)(1), I.R.C., amounts received under a life insurance contract and, under Sec. 22(b)(5) I.R.C., amounts received through accident or health insurance. These items would probably not be considered income under the Supreme Court definition in Eisner *v.* Macomber, 252 U. S. 189, viz., " 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets."

The reimbursement in this case can not be classified as a gain, because it was received in recompense for a tax payment which must be classed as an expense even though not allowed as a deduction.

The rules which apply to a situation where reimbursement offsets a deductible loss or expense do not seem to apply here. For example, Sec. 23(f), I.R.C., allows to a corporation a deduction for losses sustained and not compensated for by insurance. There is a clear implication that the insurance proceeds are not to be included in gross income

but are to be applied in reduction of the deductible loss. However, if the insurance proceeds exceed the basis of the property there is gain from conversion of the asset, which must be included in gross income. Another example is the situation which results from the payment of deductible taxes by another. Thus, when a tenant pays the landlord's realty tax the item is includible in gross income of the landlord as additional rent, but it would be offset by a deduction for real estate taxes paid. These rules, however, apply to reimbursements for deductible losses or expenses. Such rules cannot be applied to a reimbursement for unjust enrichment taxes which are considered non-deductible.

There is also question whether this item would in any case be includible in gross income of a foreign corporation. It is provided in Sec. 231(c), I.R.C., that the gross income of a foreign corporation includes only gross income from sources within the United States. None of the provisions of Sec. 119, I.R.C., regarding income from sources within the United States is directly applicable to this item. A general rule was stated in O.D. 651, 3 C.B. 265, that the source of income means the place of origin. Under this rule the source of interest payments has been held to be the place where the debtor resides. If this is the principle to be applied the source of this reimbursement would be London, the place where the insurance company is located. The item would not, therefore, constitute income from a source within the United States and would not be includible in the gross income of a foreign corporation.

There seems to be enough doubt regarding the proper treatment of this item for the corporation to protect itself by attaching to its return a statement describing the nature of the reimbursement and disclosing the fact that it has not been included in its gross income.

Note:

Another member of the committee, to whom this question was referred, was of the opinion that, had the taxpayer been a domestic corporation, the refund would have been includible in gross income in the year when the liability for tax was finally determined and liability for reimbursement accepted by the underwriter.

Question: Section 117(c) of the Internal Revenue Code provides an alternative method of calculating income taxes on individuals with net long term capital gains or losses.

Has this provision been changed by the Revenue Act of 1941?

Answer: The alternative computation in terms is continued by the 1941 Act but the 10% defense tax has been repealed and because of that the effective rates of 22% and 16½% applicable to capital gains and losses have been restored to the original rates of 20% and 15%.

However, since the alternative method comes into play when the tax rate on ordinary income reaches 30%, which is around $12,000., the sharp increase of surtax rates means that taxpayers will reach that point sooner.

Question: A taxpayer using the last-in, first-out inventory method has the same quantity of a class of items on hand at the end of the taxable year as it had at the beginning. At an interim date during the year it had no items of this class on hand. How should the inventory at the end of the year be computed?

Answer: Under Sec. 22(d), I.R.C., and the provisions of Regulations 103, Sec. 19.22(d)-1 and 2, where the taxpayer has elected to use the last-in, first-out inventory method for a particular class of items the taxpayer is permitted to treat goods of that

class remaining on hand at the close of the taxable year as being, "first, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year." Consequently, in the computation of the inventory at the end of the year the goods of this class would be included at the same amount as the inventory at the beginning of the year. The fact that there were no goods of this particular class on hand at an interim date during the taxable year would have no effect on the computation.

Question: Is a contractor who reports upon the cash receipts and disbursements basis, required to report income from long-term contracts on the basis of percentage of completion or on the completed contract basis?

Answer: The contractor is not required to report such income on either the percentage of completion basis or the completed contract basis, but is permitted to report such income on the cash receipts and disbursements basis. The Bureau has so ruled in a recent G.C.M. (G.C.M. 22682).

Question: The recipient of annuity payments must report up to 3% of the undiminished original cost of the annuity. Does it matter that such annuity is acquired under a single contract combining both annuity and life insurance features?

Answer: Yes, it does matter. Taxpayers are now discovering that under such contracts they have neither insurance nor annuities, within the meaning of the tax laws.

In the *Le Gierse* case the Supreme Court denied the $40,000 estate tax exemption accorded insurance payable to named beneficiaries, saying that the concurrent annuity arrangement cancelled out the risk element and destroyed the life insurance feature.

In the *Reynolds* case, the Board held that such a contract was for insurance and annuities in form only and was nothing more than a contract with an insurance company calling for an investment and an assured return.

Insurance companies have been requested to show the entire annuity payment under such contracts in their income information returns, Form 1099.

So, although there is no ruling or reported instance, there is now the possibility that the entire annuity payment will be taxed, not merely up to 3% of cost.

Question: In the absence of specific provision, the allowable depreciation on trust property is apportionable between the income beneficiary and the trustee, on the basis of the trust income allocable to each. The Board also has held that where depreciable property produces no net income, the income beneficiary is entitled to the entire depreciation deduction.

Who is entitled to the deduction in the following circumstances? A New York trust consisting of a real estate mortgage only, by foreclosure possesses itself of the underlying property. The trustee under a discretion sanctioned by the Courts, withheld the entire current net rental income, pending the sale of the property.

Answer: There are no rulings or reported cases on this point but the department's practice has been to treat the withheld rental income as income allocable to the trustee and to grant him the deduction.

However, much can be said for the view that under these circumstances there is no allocable *trust* income and that therefore, following the Board's decision, the income beneficiary may take the depreciation deduction.

The trustee's discretion is not to withhold the net rents as *income* but merely to reserve it against future

operating deficits or to place the withheld amounts with the proceeds of sale, to be apportioned ultimately between the income beneficiary and corpus, under the formula governing what is known as "salvage operations."

On trustee's books, the amount reserved may be said to be a charge against current income, leaving no current amount for the income beneficiary. Depreciation is apportionable according to allocable trust income as distinguished from taxable income. Since under the tax laws, such a reserve is not a recognizable deduction, the trustee will be taxed on the amount withheld—but nevertheless the income beneficiary is entitled to the depreciation deduction.

Question: Company A owns all of the stock of Company B, for which it paid $1,000 cash in 1935. Company B's balance sheet at December 31, 1940 is as follows:

Assets		
Cash		$500
Liabilities		
Due to Company A	$10,000	
Capital stock	1,000	
Deficit	10,500	500

On January 1, 1941 A sold the stock of B to the manager of B for $500 cash. On the same day it entered into a contract with B to the effect that the $10,000 debt would be liquidated by payment by B to A of 10% of the net profit of B for each of the five years ended December 31, 1945. These payments are to completely liquidate the debt, regardless of whether they total more or less than $10,000.

1. What is the tax effect to A, and in what year?

2. How should B treat the annual payments for tax purposes?

3. If after five years B has paid only $9,000, is the remaining credit of $1,000 taxable income to B?

4. If after five years B has paid $12,000, is the $2,000 a deductible loss?

Answer: It is presumed that the advances to Company B were not meant to be additions to capital. Company A could have collected the $500 cash—and emerged with a bad debt loss of $9,500 and worthless stock of $1,000, deductible as a long term capital loss in 1941 (unless facts indicate worthlessness in a prior year)—

But the willingness of the manager to pay $500 for stock without equity and probably to make additional investment to carry on business reflects a judgment that there was potential worth in the stock.

The arrangement for paying the debt out of profits was presumably made in good faith by a creditor anxious to salvage as much as possible. So even should nothing be collected under this plan, it cannot be asserted that worthlessness should have been ascertained in 1941.

In view of all this—

1. A would have a capital loss of $500 resulting from sale of stock in 1941.

2. Payments by B up to $10,000 would simply reduce its debt.

3. If, after five years, only $9,000 has been paid, B would have taxable income of $1,000 (this presumes profits of $90,000, making it solvent).

4. Payment of $2,000 in excess of debt would be deductible, it resulting from a business transaction.

Question: Is the declared value excess profits tax for the year ended June 30, 1941 deductible in computing excess profits tax for the year 1941, on the accrual basis?

Answer: The Internal Revenue Code prior to amendment by the Revenue Act of 1941 specifically provided for deduction of the declared value excess profits tax. The 1941

Act amended section 23(c) and omitted the reference to the declared value excess profits tax. However, the Commissioner of Internal Revenue has stated that this tax is still a proper deduction in computing normal tax net income, surtax net income and excess profits net income.

Question: Assume a corporation has an operating loss for the year 1940 of $50,000. This is based on ordinary operations with no capital losses deducted and no exempt income. For the year 1941 this corporation has a net taxable income (before operating loss carryover) of $100,000, which includes a deduction of a long-term capital loss of $25,000.

What amount is this corporation permitted to deduct from its 1941 net taxable income as an operating loss carryover from the year 1940?

Answer: $25,000.

Question: Assume that a corporation has a net loss for excess profits tax purposes of $50,000 for the year 1940 as shown on line 20 of form 1121. This loss arises entirely out of ordinary operations and does not include any operating loss carryover from 1939 nor is there any capital loss included therein. The excess profits credit shown on line 22 is $75,000.

To what amount is this company entitled as an unused excess profits credit carryover to be used in the calendar year 1941?

Answer: $75,000.

Question: Corporation A owns all of the stock of corporation B. Each corporation, in separate returns, showed an excess profits credit in 1940 in excess of the 1940 excess profits net income. B is merged into A on December 31, 1940. What is the excess profits carryover of A for 1941?

Answer: B's carryover from 1940 will not be available to A in 1941; A's carryover in that year will be that shown on its own separate 1940 return.

Question: A taxpayer's operations for 1940 resulted in net operating loss of $100,000. Its unused excess profits credit for 1940 on the most favorable basis, was also $100,000.

May it avail itself of both the operating loss and the unused credit in its 1941 return?

Answer: Yes.

The 1940 operating loss carryover will appear as a deduction in computing excess profits net income for 1941—and the unused 1940 credit will be added to its 1941 credit.

Question: In computing the excess profits credit carryover, is the specific exemption of $5,000 included?

Answer: No.

The carryover is limited to the amount by which the higher of the two possible credits exceeds excess profits net income, as computed under the 1941 Act.

The specific exemption of $5,000 is plainly not part of that credit, as defined by law. It is merely a supplementary annual credit given to all companies, and where not currently availed of, it disappears.

Question: Corporation A (a mercantile corporation) owned all the outstanding stock of corporation B. During 1934 the net assets of corporation B were distributed to corporation A in complete liquidation. The basis of the stock of corporation B in the hands of corporation A was $200,000, and the fair market value of the net assets of corporation B at the date of liquidation was $150,000. Corporation A had no other capital gains or losses during 1934; therefore, it was limited to a capital loss deduction of only $2,000 on account of the liquidation of corporation B. In computing the accumulated earnings and profits of corporation A, what amount should be deducted on

account of the loss resulting from the liquidation?

Answer: Section 115(1) of the Internal Revenue Code states in effect that only the gain or loss recognized in computing net income should be used in computing earnings and profits of the corporation. In the question submitted the loss was $50,000, which would be recognized under the provisions of Section 112. Therefore, the full amount of $50,000 should be deducted in computing the accumulated earnings and profits of corporation A. The fact that the deduction was limited to $2,000 has no effect on the amount recognized in this case.

Question: Where relief for excess profits tax purposes is based on increased productive capacity at 1940, and where in one of the base period years the taxpayer operated at a loss, must that loss be increased in the redetermination of base period income on the principle that if there were greater capacity, the loss would have been greater.

Answer: There are at least three points involved in this question:

1. The application of relief provisions should not have the effect of increasing the tax, but if there are several factors in the recomputation, some being favorable and others being unfavorable, the unfavorable factors cannot be ignored.

2. In the redetermination of the average base period income under the relief provision, one loss year is ignored in the same manner as in a normal case.

3. A mere increase in capacity does not necessarily provide a basis for relief. All the facts in the particular case would need to be considered.

Question: In 1935, a company deducted $400,000 on account of an adverse judgment and related legal expenses. In 1936, it deducted $150,000 more for legal expenses in the same matter. This suit was the first in the company's history.

In computing base period income, how much of the $150,000 deducted in 1936 should be excluded?

Answer: Base period income may be adjusted for deductions relating to a judgment, whether abnormal in character or only abnormal in amount.

If abnormal in character, the entire amount goes out.

If abnormal in amount—only the excess over 125% of a normal, amount, fixed by law at 125% of the preceding four years average.

Under the facts, both the 1935 and 1936 payments were abnormal—and the entire 1936 deduction of $150,000 *should be* excludible.

The department will no doubt try to hold the exclusion down to $25,000—for under the regulations, the mere presence of the deduction of $400,000 in 1935, arbitrarily makes items of this character normal to this taxpayer. The average for four previous years becoming $100,000, the retained deduction will be $125,000, leaving only $25,000 to be excluded.

But the fact remains that both the 1935 and 1936 items arose from the company's one and only suit, which was clearly foreign to the company's experience. Despite the regulations, the taxpayer should assert that the 1936 item was abnormal by class and is wholly excludible from base period deductions.

Question: A corporation organized before 1936 reported on the basis of a June 30 fiscal year. On December 1, 1939 it was succeeded by another corporation, in a tax free reorganization; the successor corporation also adopting a June 30 year. The predecessor corporation therefore filed an income tax return for the period July 1, 1939 to November 30, 1939 and the successor corpora-

tion filed a return for the period December 1, 1939 to June 30, 1940.

(1) What is the base period for the successor corporation?

(2) If the continuing corporation adopted a calendar year, and therefore filed a return for the month of December 1939, what is the base period?

Answer: (1) The first excess profits tax year is that beginning July 1, 1940. The base period is the 48 months from July 1, 1936 to June 30, 1940, and the average base period net income is 12/48th of the income for that period. The corporation may elect to include the experience of the predecessor in that period, or to construct an income for the missing months.

(2) The base period would then be the calendar years 1936-1939 inclusive. There would be zero income in the 1936 year, since the predecessor had no year which began after 1935 and ending in 1936. Thus the average would consist of three full years income divided by four.

Question: If in 1942 additional income taxes are assessed and paid for 1939, does this deficiency reduce invested capital for 1941?

Answer: Income and excess profits tax for a preceding year must be eliminated from opening surplus of a taxable year—even though paid from earnings of the taxable year.

The regulations however do not refer to additional assessments for earlier years and say nothing about retroactive adjustment and recomputation of invested capital on that account—as did regulations 45 under the old law. Yet it seems safe to prophesy that sooner or later the department will revive this old rule, certainly against taxpayers on the accrual basis.

In a case involving the amount of surplus available for dividends, a court held that a 1919 surplus should not be reduced by an additional assessment for 1918 made in 1920. So if the taxpayer is so minded, he can find ground in the case of *Duffin vs. Lucas,* for resisting any attempt to enforce retroactive adjustments.

Question: In 1917 a corporation acquired assets in exchange for its stock. In 1940 it properly includes these assets in invested capital at their fair market value in 1917. However in 1917 some of the individuals who received the stock did not pay income taxes on the gain realized by them.

Does section 734 require the corporation to pay the outlawed 1917 tax deficiencies of the individuals, who incidently may not be stockholders any more.

If yes, what of 1941, 1942, 1943, etc.?

Answer: The regulations classify the individual stockholders as predecessors. If the corporation maintains its inconsistent position, its excess profits tax for 1940 will be increased by the amount of the predecessors' unpaid taxes, with interest.

Under the regulations, an adjustmen made in the 1940 tax computation will not be repeated in subsequent years.

Significant 1941 Changes in New York State Tax Laws, Regulations and Rulings

By Isidor Sack, C.P.A.

Corporate franchise taxes

Real estate corporations — Chapter* 528 amends Section 182 of Article 9 dealing with the tax on real estate corporations. The definition of a real estate corporation which formerly included only those engaged "wholly" in the purchase and sale of real estate or in the business of subleasing real property held under a 20 year leasehold is now amended to permit the holding of purchase money obligations received on the sale of such real estate or leasehold and secured thereby.

The phraseology of the law leaves unsolved the question of whether the purchase money obligations referred to must be those received by the corporation on the sale of its own property or whether it may include purchase money obligations acquired from others.

This section also provides that a corporation does not lose its status as a real estate corporation if during the year not more than 10% of its average gross assets consisted of stocks and bonds and other securities.

In this section the law states that assets shall be taken at "full value." Just what this term means is anybody's guess.

Investment trusts — Chapter 338 deals with investment trusts. It amends Section 214(b) to include real property together with securities in determining the allocation ratio, which heretofore was determined only on the basis of securities held.

It also amends Section 208, subdivision 4, which defines an investment trust as one whose business consists principally of holding and investing securities but excludes among other tests a corporation which has less than 85% of its average gross assets invested in securities or has more than 20% invested in the securities of any one corporation, by providing that in "determining the value of gross assets under this paragraph 'full value' shall be used in the case of real property and 'cost' in the case of other assets."

This may give a clue to the meaning of the words "full value" as used here and in the amendment to Section 182 previously referred to by indicating that "full value" does not mean cost, probably meaning market value.

Emergency tax on public utilities— Chapter 137 amended Section 186-a, which imposes an emergency tax on utility service at the rate of 2% on gross income, to include as a utility any person who furnishes gas, electric, telephone or other utility service regardless of whether that is the main business of the taxpayer or whether use is made of public streets.

The amendment sets at rest the controversy as to whether companies sub-metering electricity and steam are subject to the tax, and overcomes the effect of the adverse decision† under the law as if previously read.

The amendment is made retroactive to 1937 thus apparently nullify-

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Presented at the December 8, 1941 meeting on State Taxation of The New York State Society of Certified Public Accountants.

* *All chapter references are to the laws of 1941.*

† *339 Central Park West, Inc.* v. *Graves,* 260 App. Div., 265, Aff'd. 284 N. Y.

ing the victory of those that challenged the earlier law and won. This illustrates the futility of challenging the state law and basing claims on its imperfections or ambiguity.

Business corporations — emergency tax rate continued? — Chapter 135 amends Section 214 of Article 9-A and extends the increase in the franchise tax rate of 4½% to 6% to franchise tax years beginning November 1, 1942.

This Section was subsequently amended by Chapter 520, which provides that this section "is hereby amended to read as follows" and in this latter amendment the provision extending the increased rate to 1942 was not included and as it reads the increased rate expires November 1, 1941.

Because of the way laws are passed in Albany this same thing occurs every year; one section is amended by two different bills, each amendment having a different purpose in mind and both amendments are passed and the question naturally occurs—does the statute last enacted prevail or are both amendments to be given effect.

It would seem that when the statute says, as it does, that Section 214 "is amended to read as follows" that that becomes the way the section reads.

However the Tax Commission has taken the position that where one section is amended by two laws, passed at the same session of the legislature, both amendments are in effect, and that the last enactment does not in effect supersede and nullify the changes introduced in the law passed earlier in the session.

This is a sound administrative rule but naturally raises the question as to the validity of this construction, and a taxpayer affected may reasonably assert that the last expression of the legislature should prevail.

As to the tax rate, that is repeated in another section, 215, which was amended by Chapter 135 to conform to the change then made in Section 214 and continues the 6% tax for 1942. Section 215 has not been changed by any later amendment.

Business corporations disallowed capital loss—Chapter 522 amends Section 209 of Article 9-A. This is the section which provides that the net income is presumably the same as the net income which the corporation is required to report to the United States.

The 1941 amendment eliminated a provision introduced in 1940, which said that the entire net income was presumably the same as the income which the corporation is required to report to the United States "and minus losses from the sale of capital assets not allowed as deductions in computing the entire net income which such corporation is required to report to the United States."

This had reference obviously to the net capital losses of corporations which have been disallowed in various ways under the internal revenue act since 1936.

These quoted words, introduced in 1940, are eliminated in 1941 and this raises an interesting question of construction. Prior to the amendment of 1940 the Commission allowed such losses as deductions from corporate income without any statutory provision. Does the elimination of the statutory provision indicate that the legislature thought that the provision was unnecessary or that the legislature wanted to disallow such losses to the same extent as they are disallowed federally?

Personal Income Tax Law

Foreclosure of real property—Chapter 922 changes all the rules with respect to the income tax consequences incident to the foreclosure of real property, the sale of real prop-

erty acquired at foreclosure and all related matters.

Prior to these amendments the foreclosure of a real estate mortgage gave rise to a deductible bad debt to the mortgagee and possibly a capital loss to the mortgagor. It was also possible in some cases for a mortgagee to wind up with a bad debt deduction and a capital gain from the foreclosure, and by a Supreme Court decision under the federal law*, which will probably apply locally as well, the mortgagee might be taxed on the accrued unpaid interest on the mortgage if he uses the accrued interest in the bid price for the property.

This confusion and inconsistency is done away with now. The foreclosure of a mortgage is not a closed transaction to the mortgagee. The property takes the place of the debt and no gain or loss results until the property is disposed of. It makes no difference whether the mortgagee acquires the property on foreclosure or by conveyance to him of the property in whole or partial satisfaction of the debt. He will realize no taxable gain or loss until he disposes of the property acquired, and when the property is finally sold the gain or loss is capital.

Redemption of Stock—Chapter 410 amends Section 350, Subdivision 15(c) of the Personal Income Tax Law.

This section defines the words "sale or exchange," whereas it previously included as a sale or exchange the retirement of shares of stock without qualification it now includes the retirement of shares of stock qualified by the following words: "other than the redemption, cancellation or distribution of its stock by a corporation in such a manner as to make the same in whole or in part essentially equivalent to the distribution of a taxable dividend."

It is obvious that the legislature intended to incorporate in the state law a provision similar to that contained in Section 115-(g) of the Internal Revenue Code.

The federal provision definitely states that such redemptions shall be treated as a taxable dividend. The state merely says that such redemptions shall not be a sale or exchange.

Whether a mere change in definition is as effective to accomplish this purpose, as a definite taxing provision would be, is something for quibblers to decide.

The comparable federal section has had an interesting history under the federal law. The decisions are confusing and not in agreement, and the circuit courts are in conflict.† It is to be regretted that in following a federal provision the state did not see fit to draft it in such a way as to resolve the doubts raised by conflicting federal decisions. Among the doubts that are left open is what to do with the basis of the securities redeemed if the redemption is wholly taxable as a dividend.

Section 350, Subdivision 15, was later amended by Chapter 922 which was designed to change the law with respect to loss or gain in connection with real estate foreclosures, and in its latest enactment the amendment introduced by Chapter 410 is omitted.

Quite likely the Commission will rule that all amendments are in harmony, but a taxpayer who may be adversely affected by this provision certainly has a good argument to the contrary.

Pension trusts for employees—Chapter 67 amends Section 360 of the Personal Income Tax law and the corresponding provisions of Article 9-B and 9-C dealing with state and national banks, to provide that where a taxpayer maintains a pen-

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* *Helvering* v. *Midland Mutual Life Insurance Co.*, 300 U. S. 216.

† See *William A. Patty* v. *Helvering*, C.C.A. 2, 98 F. (2d) 717. For discussion of the purpose of this section see *Hyman* v. *Commissioner*, 71 F. (2d) 342; cert. denied 293 U. S. 570).

sion trust for his employees he may deduct, in addition to the annual contribution which is allowable as an ordinary business expense, an amount transferred to the trust beyond the annual requirement, but such amount must be spread over 10 consecutive years beginning with the year in which the payment is made. This is done occasionally I learn in order to make good actuarial deficiencies in the trust due to credits for services prior to the establishment of the pension plan.

The state provision now corresponds to Section 23 (p) (1) of the Internal Revenue Code.

Emergency tax not renewed—A welcome change in the law is due to the failure to pass a law. A failure not accidental but deliberate.

Section 351-(f) of the Personal Income Tax Law imposing an emergency tax of 1% expires by its terms in 1940 and was not renewed, so the tax will not apply for incomes of 1941.

Adminstrative Changes

Appraisal of stock not required—Chapter 28 repeals Section 193, which provided for the appraisal of the value of stock by holding corporations, transportation and transmission corporations and agricultural cooperative organizations. The requirement for appraisal was meaningless, and the repeal is in the interest of sound tax administration.

Extension of time for filing returns—Chapter 28 also gives the Commission power to extend the time for filing returns under Article 9 without limitation superseding the previous provision contained in Section 192, which gave the Commission a limited power to extend the time for filing returns for real estate corporations, agricultural cooperative corporations, transportation and transmission corporations and holding corporations to a period not beyond April 1st. The provision in Article 9 now conforms to the provision of Section 217 of Article 9-A, and gives the Commission uniform powers to extend the time for filing of corporate returns—a desirable improvement.

Extension of time for payment of tax—This chapter also amends Section 197 of Article 9 and Section 219-(c) of Article 9-A permitting the Tax Commission to grant a reasonable extension of time for the payment of any tax imposed under either article.

Section 197 and 219-(c) were subsequently amended by Chapter 518, to give the Commission power to modify or compromise penalties. This latest amendment omitted the provision inserted by Chapter 28, giving the Tax Commission power to extend the time for payment of taxes. Under the theory of statutory construction adopted by the Commission as heretofore explained, all amendments passed at the session of the legislature are effective. The official print of the law contains this section in a form to give effect to both amendments.

Statute of limitations—Chapter 119 amends Section 195 of Article 9 with reference to the time within which the Tax Commission may audit returns filed under Article 9, so as to make it conform to the provision contained in Section 219-(a) under Article 9-A. The prior provision did not fix any time limit upon the audit of the return by the Commission and provided that 18 months after the audit had been made the Commission could reaudit the accounts if it was incorrect "because of manifest clerical or other errors," or without limit of time if the report was false or fraudulent.

The new provision is a welcome improvement in standardizing the two articles. It now provides, as does Section 219-(a) that the Tax Commission has five years after the report was filed to audit the tax, and that if it does not restate the tax within five years it is deemed correct as filed.

The provision states that if the audit shows an excess tax to be paid the excess tax shall be refunded. It is silent on the procedure for the payment of additional tax, if any is found to be due, and one must go to other sections of the law to ascertain when additional tax is due and when interest thereon accrues.

The additional tax based upon such reaudit is not a lien on any property of the corporation which was transferred in good faith for value prior to the restatement of the tax.

Newly organized corporations; corporations increasing or reducing stock—Chapter 520 amends Section 211 under Article 9-A which deals with reports of corporations to provide that

(1) any domestic corporation which was incorporated before November 1st, or any foreign corporation which begins business in this state before November 1st, and

(2) any corporation whose stock is increased or decreased after the close of its fiscal year and prior to November 1st thereafter, which is not subject to a franchise tax measured by net income,

shall file a report of the increase or decrease of stock, and amends Section 214 to provide that if the tax is not based on net income but on capital stock, it will be computed on the amount of capital stock outstanding October 31st.

One mill tax under Article 9-A—Business corporations are subject to several minimum taxes, one of which is a tax of one mill on the value of capital stock.

The law did not give the dates as of which the average value of the stock should be ascertained.

Chapter 520 amends Section 214 to provide that the one mill minimum tax shall be based on the average market value of the issued capital stock *during* the year, but not less than the par value or the net worth on the last day of the fiscal year, and in no event not less than $5 per share.

Although the use of three bases and fixing the tax on whichever results in the highest tax is a practice to be deplored, the amendment is nevertheless an improvement in removing doubt about the date as of which values are ascertained.

Dissolution of delinquent corporations—Chapter 590 amends Section 203-(a) subdivision 10, dealing with the dissolution of delinquent business corporations by proclamation and provides that Section 29 of the General Corporation Law shall apply to corporations heretofore and hereafter dissolved under this section.

The section of the General Corporation Law referred to continues the corporate existence for all the time necessary to wind up the affairs of a company; it may sue and be sued in the corporate name, and the directors continue to have all the powers which they had before the dissolution.

This amendment is retroactive. Prior to the amendment it was held* that the section in its previous form was not retroactive, and that a dissolved corporation was not liable for franchise tax even though it continued to do business.** Whether this amendment will change the rule in that respect remains to be seen.

Valuation of Capital Stock—Under several sections of Article 9, where corporations are taxed on the value of capital stock, the tax payable is based upon a ratio of the value of the stock which the New York assets bear to total assets.

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* *73 First Avenue Corporation, Inc.* v. *Braunstein etc. Corporation,* 168 Misc. 843, aff'd. 258, App. Div. 961.

** *Brady* v. *Tax Commission,* CCH, New York State Service (Par. 200-460).

Amendments made in 1941 provide that in computing this ratio, cash on hand and on deposit shall be excluded from the assets of the company. This is obviously designed to avoid the difficulty of deciding whether any part of the cash is a New York asset. These changes are made by Chapter 75 which amends Section 181 imposing the license tax on foreign corporations, section 183 on transportation and transmission corporations, and section 188 on holding corporations, and by Chapter 528 which amends section 182 relating to real estate corporations affecting both the quarter mill tax and the 2% dividend tax.

These amendments now make the rules uniform under Article 9 with the provision in Article 9-A for the computation of the one mill tax on business corporations.

I think that in reviewing the work of the legislature it is fair to say that the changes in tax laws were all, or nearly all, to the good.

Decisions

The decisions were few and of no great general interest.

An unincorporated business which is engaged in a profession is not subject to the unincorporated business tax. During the last year there were two decisions to the professional character of certain business. One* held that textile brokers engaged in developing new textile fabrics are not engaged in a profession, and another** held that industrial designing is a profession.

That the actual nature of the business conducted rather than the terms of the certificate of incorporation will control for tax purposes is indicated by the decision in Mortgage Company of New York *vs.* Graves, (CCH, New York Service—Par. 200-477).

In that case a corporation was organized under the insurance law to issue policies of insurance, but did not issue such policies but engaged in the business of servicing mortgages.

It was held that it was subject to tax under Article 9-A as a business corporation and not under Section 187 as an insurance company.

With so many people in the military service some "military" problems will arise in the preparation of returns next year. The State has issued three rulings of interest, (1) Salary payments to persons who enlist or are drafted in the Federal service are deductible as a business expense, (2) The value of maintenance, or amounts allowed as commutation of maintenance, to persons in military service are not taxable income, (3) The federal soldiers and sailors civil relief act of 1940, which defers for a period extending not more than six months after the termination of the service the collection of any income tax will be adopted by the state. A return must be filed and a request that payment be deferred should accompany the return together with a statement showing that the ability to pay is impaired by reason of the military service.

* *People ex rel. Heineman & Seidman* v. *Commissioner*, 22 N. Y. S. [2nd] 985.

** Matter of *Teague* v. *Graves*, 261 App. Div. 652, 27 N. Y. S. [2nd] 762, affirmed by Court of Appeals Nov. 19, 1941.

Allocation of Income and Segregation of Assets in State Taxation

By J. B. C. Woods, C.A., C.P.A.

THIS paper is concerned primarily with New York State franchise taxes, license fees payable by foreign corporations doing business in the state, personal income taxes on nonresident individuals and the unincorporated business tax on businesses carried on within and without the state, in so far as they are affected by the allocation of income and the segregation of assets. Necessarily this is accompanied by some consideration of other state tax systems affecting these same taxpayers whether they are New York corporations doing business elsewhere or foreign corporations entering this state, or individuals or partnerships (whether or not classified as unincorporated businesses) doing business, owning property or deriving income across state lines.

New York State in some instances, by means of allocation of income and segregation of assets within and without the state, determines license fees and franchise taxes on corporations organized and by definition regarded as located elsewhere but doing business within the state, and personal income taxes on nonresidents deriving income from sources within the state; by allocation and segregation determines the tax on unincorporated businesses doing business within and without the state; and by allocation and segregation also gives partial relief from taxation to New York State corporations regarded as doing business outside of the state.

Similarly, other states impose taxes on corporations foreign to them (including New York State corporations) doing business within the taxing state and on individuals not resident in the taxing state (including New York State residents) but doing business therein.

The Apportionment Formulas in New York State

A brief review of the apportionment formulas under New York State Tax Law affords a beginning for consideration of the subject of this paper.

Corporations.

The New York State formula consisting of an allocation of income based on a segregation of certain assets, namely, real and tangible personal property, receivables from sales and services, and shares of stock owned, is applicable only for franchise taxes based on income. The formula where the tax is on the value of capital stock allocated to New York State includes not only the factors mentioned, but also other receivables including loans.

For investment trusts, as defined by statute, there are separate provisions under which apportionment is permitted whether or not an office is maintained outside the state and under which the allocation formula is based on the value of stock, bonds, securities and real estate owned, located within and without the state, determined according to underlying location of assets. Not every investment company is an investment trust. A dealer in securities is not, nor is the corporation which places

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more than twenty per cent of its assets in the securities of another corporation (except a municipal corporation or investment trust). To qualify as an investment trust, eighty-five per cent of its average gross assets must remain invested in securities or in cash. That line of demarcation should be watched, otherwise the privilege of apportionment without having a place of business outside the state may disappear unwittingly.

Real estate corporations with assets within and without the state are taxed upon an apportionment of total assets and of dividends, the apportionment being on the basis of the values of the assets.

Qualification fees for foreign corporations are based on capital stock employed in New York State allocated on the basis of gross assets exclusive of cash.

Nonresidents.

The income tax on nonresident individuals is also based on apportionment to the extent that income is derived from a business carried on within and without the state either by the individual or by a partnership of which he is a member. Apportionment in these cases may be by separate accounting according to the books of the taxpayer, subject to acceptance by the State Tax Commission. Where the "books of the (nonresident) taxpayer do not disclose the proportion of . . . net income from sources within the state . . . or if the basis of apportionment" used by the taxpayer is not acceptable to the Commission, an allocation formula is used. This formula is similar to the Massachusetts formula. In order to obtain equitable treatment, where the prescribed formula would do injustice to the taxpayer, it is provided, in Article 470 of the Regulations, that: "Any nonresident may submit an alternative basis of apportionment with respect to his own income and explain that basis in full in his return. If approved by the Tax Commission, that method will be accepted instead and in place of the one herein prescribed." This privilege is, of course, extended to nonresident members of partnerships engaged in business within and without the state.

The income tax on nonresidents also rests on apportionment to the extent that the income consists of compensation for services performed within and without the state. There the allocation is on the basis of volume of business within and without the state for traveling salesmen, and on the basis of days worked within and without the state for other employees.

Unincorporated Business Tax.

For the purposes of this tax also, apportionment of income may be required, and here the methods used are similar to those which apply in the case of allocation of business income for personal income tax, discussed above. That is to say, by separate accounting according to the books of the taxpayer, subject to acceptance by the State Tax Commission, or by formula similar to the Massachusetts formula, or by the State Tax Commission where the allocation formula would not be fair and equitable.

Conclusion.

There is a trend toward the Massachusetts formula of apportionment. The New York State factors formula, used for personal income taxes and the unincorporated business tax, is similar to the Massachusetts formula. However, it has not been extended by New York State to include the determination of corporation franchise taxes and license fees.

In the tax laws of many other states the Massachusetts formula has made no headway.

Whether uniformity and equity in taxation of businesses engaged in

interstate commerce is to be achieved by agreement among the state legislatures, by a kind of compulsion through a Federal crediting device, or by integration of Federal and state taxation systems, does not matter, so long as the objective is achieved. The burdens of state taxation should be spread equitably over all incomes, including those which now escape, and double taxation eliminated.

State tax returns are of increasing importance. The time has passed when taxpayers could keep their total state taxes down to a reasonable figure by paying in some states and talking their way out of other assessments. Full disclosure is necessary, and is assured to the states by access to Federal returns. In return, states should together limit themselves or expect to be limited to taxation of one-hundred per cent of income.

The foregoing conclusion, briefly stated, is self-evident to all certified public accountants who prepare New York State returns and returns for other states for those of their clients who are subject to taxes in two or more states. The conclusion finds more objective support in a general review of state tax systems in so far as they relate to the question of allocation and segregation.

The states have broad taxing powers, but corporations admitted from other states may not be subjected to discrimination in the form of arbitrary taxation, nor may citizens of other states be subjected to taxes "more onerous in effect than those imposed under like circumstances upon citizens" of the taxing state. Under its apportionment formula New York State, until there was a court decision to the contrary, included bond interest in the taxable income and excluded the bond from the segregation of assets. It still leaves it to the taxpayer or its accountant to supplement a franchise tax return in order to obtain the benefit of that ruling. However, by and large, almost any kind of apportionment is permissible in any one state, regardless of whether the total effect of apportionment on various bases by several states is unreasonable. It is just this condition which requires a consideration of the diversity of state tax systems.

The Taxing Power of the States

The states have sovereign powers to tax in accordance with their own constitutions and exercised under their own laws, restricted only by the Federal Constitution. The breadth of that taxing power was stated by the United States Supreme Court in *Shaffer* v. *Carter* (1920) 252 U. S. 37, 40 Sup. Ct. 221. Except "as restricted by particular provisions of the Federal Constitution" the states may "resort to all reasonable forms of taxation in order to defray the government expenses." In that case it was also pointed out that the taxing "power is not confined to the people and property of a State, but (on the authority of *McCulloch* v. *Maryland* (1819), 4 Wheat. 316) may be exercised on every object brought within its jurisdiction." Further, a reference is made to the long-recognized power that "a State may tax callings and occupations as well as persons and property" and finally, quoting from *State Tax on Foreign-Held Bonds,* 15 Wall. 300, 319 it was said "unless restrained by provisions of the Federal Constitution, the power of the State as to the mode, form, and extent of taxation is unlimited, where the subjects to which it applies are within her jurisdiction."

Federal Constitutional Restrictions—General

This paper is not concerned with Federal restrictions on that taxing power except as they affect allocation and segregation for tax purposes. While the right "to regulate commerce with foreign nations, and among the several states" is re-

served to Congress by the Constitution, "the *general* rule has been laid down that a State may, if it chooses to do so, exclude foreign corporations from its limits," *Western Union Telegraph Co.* v. *Kansas* (1910), 216 U. S. 1, 30 Sup. Ct. 190. However, on the one hand, "once a state permits a foreign corporation to come in . . . the due process and equal protection clauses of the 14th Amendment protect the foreign corporation against such discrimination" as arbitrary taxation, *New York State Income and Franchise Taxes,* 1941, by Harrow and Sack, (Chapter 1) in part on the authority of *Hanover Fire Insurance Co.* v. *Harding* 272 U. S. 494; and on the other hand, "the mere fact that a corporation is engaged in interstate commerce does not exempt its property from state taxation," *Baltic Mining Co.* v. *Massachusetts* (1913), 231 U. S. 68, 34 Sup. Ct. 15. It is specifically stated that in admitting a corporation the state "may make the grant or privilege dependent upon the payment of a specific license tax, or a sum proportioned to the amount of its capital" *Horn Silver Mining Co.* v. *N. Y.* (1892) 143 U. S. 305.

As to citizens of other states, the Federal Constitution provides that "the citizens of each state shall be entitled to all privileges and immunities of citizens in the several states." In accordance with that clause it has been said "That a State . . . may not prohibit the citizens of other states from carrying on legitimate business within its borders like its own citizens, of course is granted; but it does not follow that the business of non-residents may not be required to make a ratable contribution in taxes for the support of the government. On the contrary, the very fact that a citizen of one State has the right to hold property or carry on an occupation or business in another is a very reasonable ground for subjecting such non-resident, although not personally, yet to the extent of his property held, or his occupation, or business carried on therein, to a duty to pay taxes not more onerous in effect than those imposed under like circumstances upon citizens of the latter State." *Shaffer* v. *Carter,* supra.

Federal Constitutional Restrictions—Specific

More specifically as to allocation and segregation, and here direct acknowledgment is made to Harrow & Sack (Chapter 1, above), reference should be made to a few decisions which indicate limitations on the taxation of corporations foreign to the taxing state. "It has been held a violation of the due process clause for a state to impose a tax on the property of a foreign corporation located and used beyond the jurisdiction of the taxing state, and any franchise or license tax which has that effect is equally invalid. Thus, a tax based on all of the authorized capital stock of a corporation was held to violate the due process clause (of the Federal Constitution, *International Paper Co.* v. *Mass.* (1918) 246 U. S. 135, although the same statute was sustained when it set a maximum limit to the possible tax, *Baltic Mining Co.* v. *Mass.* (1913) 231 U. S. 68; *Cheney Bros. Co.* v. *Mass.* (1918) 246 U. S. 147.

"In *People ex rel. Alpha Portland Cement Co.* v. *Knapp* (1920) 230 N. Y. 48, the Court held that it was improper for a state to include as part of the basis for levying a franchise tax, interest on the bonds of a foreign corporation without using the bonds as one of the assets in the apportionment formula to determine the portion of income taxable in the state. * * *

"To be valid, a tax upon receipts, income or capital of a foreign corporation must be based upon some method of apportionment which segregates for taxation, only so much of the receipts, income or capital as may properly be said to have been

derived from the business carried on within the state. * * *

"* * * a state tax upon the net income of a foreign corporation prorated in a reasonable manner is not invalid. * * * The Supreme Court held that this method of allocation was not inherently unreasonable and was not calculated to tax income earned beyond the borders of the state." The tax was imposed on that portion of net income from all sources which the value of real and tangible personal property within the state bore to the value of all the real and tangible personal property of the corporation, *Underwood Typewriter Co.* v. *Chamberlain* (1920) 254 U. S. 113.

The New York State formula for a franchise tax measured on a proportion of net income of a foreign corporation was upheld in *Bass, Ratcliffe & Greton* v. *Com.* (1924) 266 U. S. 271, even although the New York branch was not profitable.

Also, the California franchise tax on a proportion of net income of a foreign corporation engaged in both intrastate and interstate commerce was upheld, although a tax on *gross* earnings from interstate commerce would have been invalid under the commerce clause of the Federal Constitution, as also would a tax on a proportion of net income of a corporation doing only interstate business in California, *Mason Navigation Co.* v. *State Board* (1936) 297 U. S. 441. As to the last point, the rule had been laid down in *Alpha Portland Cement Co.* v. *Massachusetts* (1925) 268 U. S. 203 where a New Jersey corporation with a principal office in Pennsylvania and a sales office in Boston was relieved of the Massachusetts franchise tax which was based on a proportion of the total value of capital shares attributed to such sales office, the tax in that instance being declared unconstitutional.

Diversity of State Tax Systems

Despite Federal restrictions, therefore, the broad taxing powers of the states remain, as indicated, both broad and powerful. Under such conditions diverse tax systems have developed.

The New York State Tax Commission knows all about the lack of uniformity and the possibilities for uniformity in state tax systems. In 1935 a special report, No. 8 of a series, was prepared for the Commission by Dr. Richard A. Girard, New York University, entitled *The Scope for Uniformity in State Tax Systems.* That report reviews and compares the state tax laws and their administration, including local taxation, and the various kinds of taxes levied. The diversity of tax systems is established and a case made for uniformity in principle. A model tax system is submitted which includes the personal income tax and a business tax.

The movement in favor of uniformity is pertinent to the subject under consideration, because under uniform tax systems most of the difficulties and inequities related to taxation of business and individuals with interstate transactions by means of allocation and segregation would disappear.

Since 1907 the National Tax Association has advocated uniformity, and for many years the Massachusetts formula of allocation. In October, 1939 its Committee on Allocation of Income, under the chairmanship of Leo Mattersdorf, C. P. A., after a year's research including the use of separate questionnaires addressed to tax commissions and corporations, not only advocated uniformity but stated that it could be attained. That committee, as its name implies, was not primarily concerned with uniformity in general but with questions of allocation of income. As part of its study it had requested The American Institute of

Accountants to appoint a committee to offer suggestions on the problem. In its report, Mr. Mattersdorf's committee includes the report of the Institute committee "favoring the general adoption by the states of statutory provisions for the election by each taxpayer to have its tax measured by income determined upon the basis of accounts and records kept in a manner which fairly reflects the income earned in each state." Mr. Mattersdorf's committee adopted that recommendation as a contribution to the solution of the problem wherever such determination of income would apply. The further recommendations of the National Tax Association committee included direct allocation to the state in which the business is carried on of financial income of manufacturing and mercantile businesses; a consistent basis of valuation of tangible personal property in each state in which the taxpayer is subject to tax; and a Solomon's solution to the question of the situs of sales, fifty per cent to be "apportioned to the state of destination of the merchandise shipped by the taxpayer, and fifty per cent to the state from which the salesmen making the sales function." The report should be read and may be found in the Proceedings of the Thirty-Second Annual Conference, 1939, National Tax Association.

Despite the recommendations of the National Tax Association, referred to above, various groups of state tax officials, the American Legislators' Association, and the special report of the State Tax Commission, mentioned above, there continues to be no uniformity to boast of. As corporations carry on business in many states foreign to that in which they are organized and foreign to that in which is located their principal place of business and as individuals and partnerships derive income from many states, these diverse systems of taxation are a source of continued inequity. A state with its own tax laws, and its residents and corporations organized under its laws, together confront other states and their homegrown tax laws.

Some businesses becomes subject to taxes in whichever state they have a stop-over, while other businesses doing no business in the states in which they have their statutory offices contrive to explain away their carrying on taxable business in any state.

It is to the interest of the states and also of taxpayers in the long run to avoid loopholes in tax laws or their administration through which some businesses escape untaxed while some are subjected to double taxation.

Where the tax is measured by property, each item of property should have one situs and only one and its method of valuation should be definite. Where the tax is measured by income, which is the best criterion of the ability to pay, the taxable income from all sources should be so allocated as to subject all of its parts to one tax and only one. Such equity could be achieved by state tax laws with uniform features, each state foregoing the advantage of a method or formula weighted in its favor in exchange for its own residents and corporations being subjected to similar treatment by other states. The question may be asked: Will it be achieved that way?

Allocation of Corporate Income for Taxation by the States

While this paper is concerned not only with allocation of income but also with segregation of assets of taxpayers, whether incorporated or not, a review of the present practices of allocation of corporation income for state taxation is illustrative of the whole problem and may be the more easily made because of an available study.

In 1933 a special report, No. 6 of a series, was prepared for New York State Commission by Dr. Robert S. Ford, Columbia University, entitled *The Allocation of Corporate Income for the Purpose of State Taxation.* As stated in its preface, the chief purpose of that report "is to analyze the nature of the friction which arises out of non-uniform allocation practices and to suggest possible methods of reform." A point is made that the taxation of international and interstate business is handled with a technique set up to deal with intrastate operations only. In introducing the subject, doubt is cast upon the probability of states adopting uniform practices. Instead, the "crediting principle" such as had been adopted for estate and inheritance taxes and has since been used for compelling a minimum standard of taxes for unemployment insurance is favored as a solution, unless an integration of Federal and state systems of taxation can be achieved.

The heart of the problem lies in the fact that after financial income of business corporations is allocated to the state in which the property is owned, there remains income from buying, processing, manufacturing, storing and selling to be allocated to the taxing states. In establishing arbitrary formulas to meet this situation each state tends to favor itself, a manufacturing state allocating income to that function while a state in which distribution predominates allocates sales to itself, that is, the state of destination of the merchandise. A classic example is the case of *Underwood Typewriter Company* v. *Chamberlain,* supra, where forty-seven per cent of its real estate and tangible personal property was situated in Connecticut while eighty per cent of its gross earnings arose from the sale of manufactured products in other states. Connecticut taxed not twenty per cent but forty-seven per cent of the income.

A fundamental question is: Should an enterprise be considered as a unity or as a consolidation of separate units? If the whole business is treated as having economic unity, an allocation by fractional apportionment may be used, and the problem is one of determining an equitable formula, or separate accounting may be adopted. If the business at each separate location is treated as a separate unit and not a part of a whole, then the only basis for allocation is separate accounting. The question of unity *versus* separate units is often encountered together with the parent and subsidiary relationship, branches being separately incorporated. In that case: should consolidated returns be permitted as a means of establishing an economic whole? Finally, whether or not branches are separately incorporated, whether or not an economic whole is ordinarily recognized, whether or not separate accounting or fractional apportionment is ordinarily applied: Where there is a loss as a whole, should a profitable branch in one state be taxed on its income? And conversely: Where there is a profit as a whole, should a branch with a net loss be taxed on a proportion of the total income of the enterprise?

Whichever method of allocation is adopted, fractional apportionment or separate accounting, the anomaly of two or more states taxing more than one hundred per cent of the income should be avoided. The case for fractional apportionment rests largely on simplicity. The method is arbitrary, of course, and its accuracy cannot be proved. One effect of the arbitrary allocation fraction may be to tax a portion of the profits of the whole enterprise in a state in which nothing was earned. On the other hand, if allocation is to be by separate accounting for each branch, the fairness of the billing price for inter-company or inter-branch sales is significant. In fact the whole question of inter-company transactions is here

important. A whole enterprise may so manipulate its internal transactions as to show its principal income in one of the many states without a tax measured on corporate income, or merely to show income in states which do not tax with the inequity of the old rule in Connecticut, mentioned above. In opposition to the use of separate accounting for allocation it is stated: "No profit is actually realized from any phase of an integrated business until the final sale is consummated. Business processes—manufacturing, warehousing and selling—cannot be separated for the computation of an independent profit," page 33 of Dr. Ford's report. Nevertheless, in the case of *Hans Rees' Sons* v. *State of North Carolina* (1931) 199 N. C. 42, 153 S. E. 850, 51 Sup. Ct. 385, the Supreme Court upheld a segregation and allocation of income by separate accounting although the North Carolina statute subjected this foreign (New York) corporation to an allocation of income on the basis of location of real and tangible personal property.

Most of the states levying a tax measured by corporate income prescribe a fractional apportionment method of allocation. There have been many decisions as to the legality of taxes imposed under such formulas, several of the more important being referred to in this paper. "The net effect of the decisions * * * is that any formula will be sustained unless the taxpayer submits convincing evidence and proof that it operates inequitably when applied to his business," page 42 of Dr. Ford's report.

There are so many different kinds of fractional apportionment in the several states that only a tedious listing of methods which defy classification would suffice to cover the field. The more important methods are those of New York, Massachusetts and Wisconsin.

In Wisconsin rents and royalties are allocated to the state in which the property from which they are derived is situated and dividends and interest are allocated to the principal place of business. The balance of income is apportioned on the basis of the average of three ratios, namely, tangible property, manufacturing expenses, and sales, within and without the state, the situs of a sale being the sales office.

In Massachusetts, the excise tax, in part on net income and in part on the value of capital stock over the value of certain property, rests partly on an allocation fraction consisting of the average of three ratios of property, payroll, and gross receipts, within and without the state, with interest and dividends allocated direct but differently than under Wisconsin law.

For New York State franchise tax under Article 9-A of the Tax Law, and where (instead of the tax being based on the value of capital stock) the tax is measured by net income or a modification of net income under the formula for compensation of officers, the fractional apportionment is upon the value within the state to the total value within and without the state of the sum of real and tangible personal property, receivables arising from the sale of personal property and services performed, and shares of stock of other corporations. The shares of stock of other corporations owned are apportioned according to the location of the assets of such issuing corporations except such assets as patents, goodwill and the like.

Under New York and Massachusetts laws there can be no apportionment of income within and without the state by the mere sale of merchandise without the state. There must be a branch outside of the state in order to permit apportionment. Under a 1940 amendment to the New York Tax Law, (Section 214 subsection 11) effective for the tax year beginning November 1, 1941, the holding of real estate

outside the state entitles a corporation to apportionment. The acquisition of real estate thus appears to offer the means for an equitable apportionment of all business done outside the state without the necessity of opening a branch office.

Dr. Ford (page 73) estimated that in New York State nearly one hundred thousand corporations, constituting about-one-third of the total number of business corporations, do business within and without the state; about seventy per cent thereof use the statutory segregation formula, about twenty-five per cent use an alternative allocation fraction, and for about five per cent the tax is based on a separate accounting. The alternative formula is allowed under section 214 subsection 7(a) of the Tax Law permitting equitable treatment. In Massachusetts the statutory formula is generally used, but a modified method is permissible and a foreign corporation may make a case for the basis of a separate accounting.

It is evident that diversity of tax systems leads to double taxation. For instance, goods manufactured in and shipped from New Jersey, on orders taken and billed for in New York, appear in the tax basis of two states, and if there should be a stop-over for warehousing in a third state, the transaction would be thrice taxed. Another example: With most of the physical assets and payroll in Connecticut through operation of a plant, most of the gross receipts would be allocated there, while most of the sales might also be allocated to New York where the sales are effected and the receivables created.

On the contrary, tax avoidance has been sought, for example, by a foreign corporation operating in New York as an investment company and claiming that its New York transactions (its only business transactions as a matter of fact) did not constitute doing business in this state. If that were permitted such a corporation would pay no franchise tax to any state.

The elimination of double taxation requires, as Dr. Ford says, an agreement on the principles of a proper allocation and an adoption of uniform procedure. When he comes to making concrete suggestions he concludes that: "The attempt to achieve uniformity by voluntary interstate agreements would delay settlement of the allocation problem for many years," page 117. Turning to compulsion, he refers favorably to the indirect method through a Federal crediting device such as is used in inheritance taxation, and as has been advocated by Commissioners Graves and Merrill of New York State. For a long-time objective Dr. Ford advocates the integration of Federal and state tax systems.

As stated by Assistant Secretary of the Treasury John L. Sullivan, in a recent address published in the November 1941 issue of TAXES (the tax magazine), the Treasury is studying and planning a co-ordination of Federal, State and Local taxes. If effective, such co-ordination would provide a general solution for the problem here discussed, the taxation of income derived without regard to state boundaries.

Non-Profit Institutions Accounting

At a special technical meeting of the Committee on Non-Profit Institutions Accounting, held on October 14, 1941 at the Society's office, questions relating to this phase of accounting were asked and discussed informally by those present. The high-lights of the meeting are presented herewith in question and comment form.

Question: There are religious non-profit institutions which own tax-free real estate. Such institutions often do not show their properties on their balance sheets, but instead show only the position of the current funds with which they operate. Would the Committee discuss this practice?

Comment: The more general practice would be to carry the real estate on the books at cost, if the cost is known. If, however, the real estate was donated and the donor does not wish to disclose the cost, then the institution might have an appraisal made and record the real estate at the time it is received at such appraised value.

On the other hand, it is the adopted policy of some institutions to record real estate and equipment at a nominal value, such as one dollar for each parcel of land, each building, or the equipment at each location, and to show, parenthetically or in a footnote, the assessed or appraised value of the assets.

The practice mentioned in the question of omitting the real estate from the balance sheet entirely does not appear to meet the accepted concept of displaying all important asset and liability items on the balance sheet. In so far as published balance sheets are concerned, such practice does not appear to be encountered very frequently.

The fact that the property is tax-free does not affect its status on a balance sheet. A balance sheet should show all the assets. Some organizations list such assets at cost value at date of acquisition and others list property assets at a nominal value of one dollar per parcel. This asset value is then of course offset by the accountability on the other side of the balance sheet showing the investment in property as indicated.

Question: Under present economic conditions how should a certified public accountant advise an institution upon the type of asset it is best to hold? Suppose $100,000 came to a non-profit religious institution through a will, how should it be invested? Or should it be left in cash? If in cash, how much should remain on hand and how much should be in savings or checking accounts?

Comment: It is not the responsibility of the certified public accountant to advise the institution as to how it should invest gifts received. The charter, by-laws or other fundamental document of the institution ordinarily charge either the board of trustees, the investment committee, or some other body with such responsibility, and would be unwise for the certified public accountant to encroach upon the function of such bodies.

Question: Some non-profit institutions do not get their fuel, electric light, or groceries free. Shouldn't such institutions also pay a fair fee for the great responsibility which the certified public accountant assumes through an audit?

Comment: When an accountant renders services either gratis or on a sub-normal fee basis, he is in effect making a donation to the organiza-

tion to the extent that his fee is less than his normal charge for services. Unfortunately, this donation is of a character which is seldom recognized as such because the fact that a donation has been made and the extent thereof lie concealed in the operating accounts. Obviously it never appears on the published list of donors. Moreover, when the service is rendered gratis or on a subnormal basis, the tendency is for the client to overlook the true value of the service.

The opinion is rapidly crystallizing that as a long-range general policy, the fees charged to such institutions should be based upon normal or nearly normal rates, and that donations by public accounting firms should be made in cash. The amounts of these donations are under the control of the accountants and would be measured by the net amounts of fees which they desire from such engagements and by the interest of the accountants in the objectives of the non-profit institutions.

Question: What are the accounting problems confronting the newly organized non-profit medical and hospital plans under Article 9C of the State Insurance Law?

Comment: The subject of non-profit medical and hospital service corporations permitted under Article 9C of the Insurance Law has become a new and interesting field in the ever enlarging scope of non-profit institutions accounting.

For instance, consider the Associated Hospital Service of New York, more commonly called the "three cents a day plan." The accounting problems concerning the audit are rather unique, in that the Associated Hospital Service is primarily a collection and disbursing agency for its member hospitals. The law specifically waives any initial capital or working capital as contra-distinguished from the requirements for a stock or mutual insurance company, which is required to place a deposit of $100,000 before the beginning of operations.

Under this program the member hospitals become co-insurers and any losses sustained during the course of operations result in a proportionate reduction in the payment of benefits to these hospitals. In other words, if the income for a fiscal year is $10,000,000 and the expenses, including payments to hospitals, amount to $11,000,000 the excess of expenses over income, namely, $1,000,000, must be divided proportionately over the member hospitals in the ratio that the number of subscriber hospital days bears to the total of hospital days. The accountant, therefore, must be most exact in setting up the proper reserves for claims for hospital services, unearned premiums, and contingencies.

A special ruling of the Insurance Department prescribed that a reserve for contingencies must be equivalent to one-half of the surplus as of December 31, 1940, plus four per cent of the earned premium until it is equivalent to 20 per cent of the loss sustained for the previous year. A maximum of 25 per cent of the current year's writings is prescribed.

As to the assets of the hospital service corporation, the classification of assets is similar to that for mutual and stock insurance companies, namely admitted assets. Investment of excess funds is guided by the same rules and laws adopted for life insurance companies. Equipment, furniture and fixtures, and the like are not capitalized but are charged off as expenses in the years in which they are purchased. As to liabilities and surplus, the accountant is guided in some measure by the practices currently in use by the stock and mutual insurance companies in the determination of claims for hospital services. Unearned pre-

mium reserves can be computed with comparative ease. Surplus and other reserves are strictly in accordance with the regulations of the Insurance Department and the Laws of the State of New York.

The Insurance and the Membership Corporation Law specifically exempts these corporations from all forms of taxation. However, the Federal Government has taken issue with the legality of that statute relative to social security taxes.

The Associated Hospital Service was organized several years ago and since its inception has paid out to its member hospitals over $28,000,000 in benefits. The balance sheet discloses reserves and capital running into the millions.

The growth of these non-profit medical and hospital corporations will, in the future, present interesting accounting problems and, therefore, a knowledge of their operations should be made available to all accountants not only because of the interest in their accounting structure but also because a million and one-half New Yorkers are covered at present under one plan.

Question: If a fund has been established for the benefit of a number of institutions, with no statement as to the portion of the principal that belongs to each, what amount should be reflected on the balance sheet of an institution which is one of the beneficiaries of the fund?

Comment: If allocation has been made of the income arising from such fund, an institution should include among its endowments that proportion of the fund represented by the proportionate share of the income, if that is possible. Otherwise, the situation should be indicated by a footnote on the balance sheet.

Question: Should provision be made for depreciation of plant assets of educational institutions?

Comment: The plant assets of educational institutions are divided into three general types:

1. Educational plant — Depreciation is not advisable since the plant was built for the benefit of students of the present generation. If depreciation is to be recovered, the present students would in effect be donating plant for a future generation.

Depreciation on educational plant however is sometimes computed for statistical information:

a. To compute unit costs of instruction,

b. To establish current values for insurance purposes,

c. To give a guide as to the amount to be expended yearly for actual maintenance.

2. Auxiliary plant — Depreciation is not generally advisable for the same reason as above, unless the terms of a building fund are such as to require its perpetuity.

3. Fund investments in form of real estate — Depreciation is advisable in order to protect the investment value.

In any event, if depreciation is set up, it must actually be set aside in cash; mere book entries will not provide for replacement of the asset.

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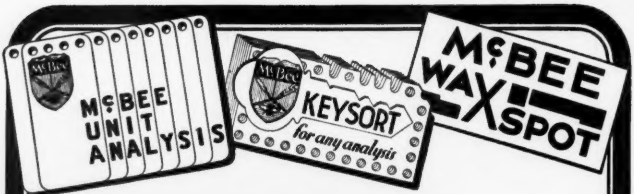

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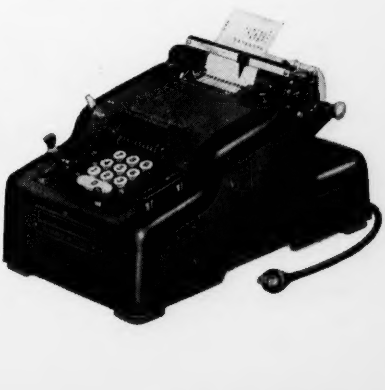

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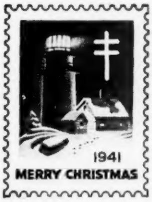

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